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PETITION FOR A WRIT OF CERTIORARI

Petitioners respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Sixth Circuit in this case.

OPINIONS AND ORDER BELOW

The opinion of the court of appeals (Pet. App. 3a-14a) is published at 414 F.3d 614. The court of appeals' order denying Petitioners' timely petition for rehearing en banc (Pet. App. 1a-2a) is not reported. The memorandum decision of the district court (Pet. App. 15a-26a) is published at 309 B.R. 738. The memorandum decision (Pet. App. 27a-51a) of the bankruptcy court is not reported.

JURISDICTION

The judgment of the court of appeals was entered on July 11, 2005. Pet. App. 3a. The order denying Petitioners' timely petition for rehearing en banc was entered on October 3, 2005. Pet. App. 1a. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

RELEVANT STATUTORY PROVISIONS

11 U.S.C. § 365 provides, in relevant part:

(g) Except as provided in subsection (h)(2) and (i)(2) of this section, the rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease—

(1) if such contract or lease has not been assumed under this section or under a plan confirmed under chapter 9, 11, 12, or 13 of this title,

immediately before the date of the filing of the petition

....

11 U.S.C. § 502 provides, in relevant part:

(g) A claim arising from the rejection, under section 365 of this title or under a plan under chapter 9, 11, 12, or 13 of this title, of an executory contract or unexpired lease of the debtor that has not been assumed shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.

STATEMENT OF THE CASE

In accordance with this Court's precedents, the lower courts have consistently applied state law to determine the damages to which a party is entitled as a result of a bankruptcy trustee's or debtor-in-possession's rejection of an executory contract or unexpired lease. Despite this uniform practice, the court of appeals below concluded that 11 U.S.C. §§ 365(g)(1) and 502(g) left no "gap" for state law to fill and that, therefore, Section 2-713 of the New York Uniform Commercial Code did not apply to the calculation of Petitioners' damages. Because the calculation of rejection damages is pervasive in bankruptcy proceedings, the court of appeals' decision concerns an important question of federal bankruptcy law. Furthermore, the court of appeals' decision conflicts with a decision of the Fifth Circuit and conflicts in principle with a decision of the First Circuit. Finally, the court of appeals' decision is wrong on the merits.

A. Statutory Context

A trustee or debtor-in-possession in a bankruptcy proceeding may, subject to the bankruptcy court's approval, "assume or reject any executory contract or unexpired lease of the debtor." 11 U.S.C. § 365(a) (2002).¹ With certain exceptions that are not relevant here, the rejection of an executory contract or unexpired lease constitutes a breach of such contract or lease "immediately before the date of the filing of the petition" 11 U.S.C. § 365(g)(1) (2002). The resulting breach of contract claim is determined and either allowed or disallowed "the same as if such claim had arisen before the date of the filing of the petition." 11 U.S.C. § 502(g) (2002).² The effect of construing a claim for

¹ Section 365(a) refers to the "trustee." However, in a Chapter 11 bankruptcy proceeding, the debtor-in-possession generally has all powers, including the power to reject executory contracts and unexpired leases, that a trustee would otherwise have. 11 U.S.C. § 1107(a) (2002).

² On October 17, 2005, a new version of § 502(g) came into effect as a result of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), Pub. L. No. 109-8, § 562(b), 119 Stat. 23, 184. The new 11 U.S.C.A. § 502(g)(1) (West Supp. 1 2005) is identical to the previous 11 U.S.C. § 502(g) (2002) that the lower courts applied in this case. The new § 502(g)(2) provides that "[a] claim for damages calculated in accordance with section 562 shall be allowed under subsection (a), (b), or (c), or disallowed under subsection (d) or (e), as if such claim had arisen before the date of the filing of the petition." 11 U.S.C.A. § 502(g)(2) (West Supp. 1 2005). New section 562 provides, in pertinent part, that, for securities contracts and certain other financial instruments, rejection "damages shall be measured as of the earlier of—(1) the date of such rejection; or (2) the date or dates of . . . liquidation, termination, or acceleration." 11

rejection damages as arising prepetition is threefold: (1) the non-breaching party is stayed from commencing an action outside the bankruptcy proceeding to enforce its claim; (2) the claim will be discharged in the bankruptcy proceeding; and (3) the "claim will . . . share pro rata with the claims of other general unsecured prepetition creditors." Ralph Brubaker, *Rejection of Executory Contracts and the Nondebtor Party's Resulting Breach Claim: Exploring the Limits of the Code's Fictional Prepetition Breach*, 25 BANKR. L. LETTER No. 12, Dec. 2005, at 1, 2 (internal citations omitted).

B. Factual Background

In May 2001, in connection with a credit agreement between Petitioners³ and Respondent American HomePatient, Inc., a Delaware corporation ("AHP"), AHP entered into a warrant agreement ("Warrant Agreement") that called for AHP to issue two series of warrants which, when exercised, would permit the warrant holders to purchase 3,265,315 shares of AHP's stock at an exercise price of \$0.01 per share. Pet. App. 4a. The Warrant Agreement provided that

U.S.C.A. § 562(a) (West Supp. 1 2005). The warrant agreement at issue in the instant case likely qualifies as a "securities contract" under the Bankruptcy Code. See 11 U.S.C.A. § 741(7)(A) (West Supp. 1 2005). However, this new version does not apply to cases commenced before April 20, 2005, including this case. BAPCPA § 1406. Regardless, the court of appeals' reasoning extends far beyond the scope of the new §§ 502(g)(2) and 562. Accordingly, the recent amendments to the Bankruptcy Code do not diminish the importance of the question presented or obviate the conflict between the court of appeals' decision and a decision of the Fifth Circuit.

³ "Petitioners" refers, as appropriate, to Petitioners and/or Petitioners' predecessors-in-interest.

Petitioners would be the warrant holders. *Id.* On July 31, 2002, AHP and twenty-four of its affiliates and subsidiaries, collectively Respondents herein, filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code. *Id.* In May 2003, the bankruptcy court confirmed Respondents' reorganization plan, which became effective on July 1, 2003. *Id.* at 4a-5a. The plan authorized Respondents to reject executory contracts on or before July 11, 2003. *Id.* at 5a.

On July 11, 2003, Respondents filed a notice of rejection and moved for an order authorizing them to reject the Warrant Agreement and to quantify the damages arising from the rejection. Pet. App. 5a. The bankruptcy court set a hearing to consider Respondents' motion and to determine rejection damages. *Id.* In pre- and post-trial memoranda, Petitioners argued that the Bankruptcy Code did not establish a valuation date for rejection damages and that, under applicable New York law, rejection damages should be calculated based upon the value of AHP's shares on the date of rejection, which would result in an award of damages to Petitioners of \$6,987,774.10. J.A. 310-12, 321-23.^{4,5} In a

⁴ Section 2-713(1) of the New York Uniform Commercial Code provides:

(1) Subject to the provisions of this Article with respect to proof of market price (Section 2-723), the measure of damages for non-delivery or repudiation by the seller is the difference between the market price *at the time when the buyer learned of the breach* and the contract price together with any incidental and consequential damages provided in this Article (Section 2-715), but less expenses saved in consequence of the seller's breach.

N.Y. U.C.C. Law § 2-713(1) (McKinney 2001) (emphasis added).

memorandum decision, the bankruptcy court rejected Petitioners' argument and concluded that "the Code provides for the allowance of the claim arising from rejection in the amount that [Petitioners] would have recovered as of the time the petition was filed." Pet. App. 44a. In accordance with this conclusion, the bankruptcy court calculated Petitioners' rejection damages as \$846,369.85. *Id.* at 50a.⁶

In the bankruptcy context, the non-breaching party will learn of the breach when it learns of the rejection of the executory contract or unexpired lease. Since the trustee or debtor-in-possession in proceedings under chapters 9, 11, 12, or 13 may generally reject or assume an executory contract "at any time before the confirmation of a plan," 11 U.S.C. § 365(d)(2) (2002), the non-breaching party will frequently not learn of rejection until a considerable period of time after the filing of the petition. 2 JAMES J. WHITE & ROBERT S. SUMMERS, *UNIFORM COMMERCIAL CODE* § 15-5 (4th ed. 1995) ("In a large Chapter 11, confirmation of the plan may come years after the petition is filed.").

⁵ Petitioners made this damage calculation by multiplying 3,265,316 (the total number of warrants) by the difference between \$2.15 (AHP's share price on July 11, 2003, the date of rejection) and \$0.01 (the exercise price per warrant). Pet. App. 50a & n.7.

⁶ The bankruptcy court made this calculation by multiplying 3,265,316 (the total number of warrants) by the difference between \$0.2692 (the bankruptcy court's finding of the value of the warrants on July 30, 2002, the date immediately prior to the filing of the bankruptcy petition) and \$0.01 (the exercise price per warrant). Pet. App. 48a, 50a. Although the bankruptcy court, district court, and court of appeals all misstate the petition-date warrant value as \$0.02692, *id.* at 50a, 18a, 6a, the result of the calculation that the bankruptcy court performed indicates that it relied upon a value of \$0.2692.

Upon appeal to the district court, Petitioners again argued that New York law governed the determination of rejection damages. Pet. App. 24a. The district court affirmed the bankruptcy court's decision, concluding that 11 U.S.C. § 502(g) established the valuation date for rejection damages and that, to the extent that New York law applied, "it conflicts with § 502(g) of the Bankruptcy Code and . . . must yield to the superceding federal law." *Id.*

C. Court of Appeals' Decision

Before the court of appeals, Petitioners argued (1) that 11 U.S.C. §§ 365(g)(1) and 502(g) do not require that the amount of rejection damages be fixed as of the date that the bankruptcy petition is filed and (2) that the bankruptcy and district courts erred in not applying Section 2-713 of the New York Uniform Commercial Code to the calculation of Petitioners' damages arising from Respondents' rejection of the Warrant Agreement. Pet. App. 7a, 13a. The court of appeals rejected Petitioners argument after consulting an on-line dictionary to discern the meaning of "determined" in 11 U.S.C. § 502(g). *Id.* at 9a. Thus, "[r]eading the word 'determine' to mean 'fix the boundaries of,' [the court of appeals] conclude[d] that section 502(g) requires that damages be fixed as of a date 'before the filing of the petition.'" *Id.* (citation omitted). The court of appeals proceeded to consider the applicability of Section 2-713 of the New York Uniform Commercial Code, stating that "[r]esort to state law is appropriate and/or necessary when a gap exists in federal bankruptcy law." *Id.* at 13a. Based upon its previous discussion of 11 U.S.C. §§ 365(g)(1) and 502(g), the court concluded that, "[a]s these specific provisions leave no 'gap' and, therefore, control any conflicting provisions of state law, the Bankruptcy Court did not err when it relied on the July 30, 2002, pre-petition date as the valuation date." *Id.* at 14a.

As a result of this conclusion, Petitioners' claim for \$6,987,774.10 was denied, *id.* at 8a, and judgment entered which reduced Petitioners' claim to \$846,369.85, *id.* at 6a, 14a.

REASONS FOR GRANTING THE WRIT

I. REVIEW BY THIS COURT IS NECESSARY TO RESOLVE AN IMPORTANT QUESTION OF FEDERAL BANKRUPTCY LAW AND TO RESOLVE A CONFLICT BETWEEN THE COURTS OF APPEALS

The question presented "implicates first principles of executory contract law and the effect of rejection on an executory contract." Brubaker, *supra*, at 1. As this Court has repeatedly stated, "[c]reditors' entitlements in bankruptcy arise in the first instance from the underlying substantive law creating the debtor's obligation, subject to any qualifying or contrary provisions of the Bankruptcy Code." *Raleigh v. Illinois Dep't of Revenue*, 530 U.S. 15, 20 (2000) (citing *Butner v. United States*, 440 U.S. 48, 55 (1979); *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 158, 161-62 (1946)); see also *Nobelman v. Am. Sav. Bank*, 508 U.S. 324, 329 (1993) (citations omitted). Thus, "[t]he existence and amount of the bankrupt's liabilities, although determined by the bankruptcy court in allowing or disallowing claims, will inevitably be determined by nonbankruptcy, usually state law." Vern Countryman, *The Use of State Law in Bankruptcy Cases* (pt. 1), 47 N.Y.U. L. REV. 407, 412 (1972). Accordingly, "state laws are [] suspended only to the extent of actual conflict with the system provided by the Bankruptcy Act of Congress." *Butner*, 440 U.S. at 54 n.9 (citations omitted).

Prior to this case, the lower courts, in particular the Fifth Circuit, have found no difficulty in applying this Court's precedents and in properly interpreting 11 U.S.C. §§ 365(g)(1) and 502(g). Courts have not construed "determined" in § 502(g) to foreclose all consideration of post-petition events in the determination of rejection damages and have consistently applied state law to determine such damages. See cases cited *infra* note 7; cf. 4 ALAN N. RESNICK ET AL., COLLIER ON BANKRUPTCY, 15TH EDITION REVISED ¶ 502.08[2][b] (2005) ("The amount of a prepetition claim arising from the rejection of a lease or contract may depend upon when a contract is rejected."). However, despite the stability that has hitherto existed, the court of appeals' decision threatens to unsettle this important area of federal law. Accordingly, this Court's consideration of the question presented is necessary to answer an important question of federal law and to resolve a conflict between the courts of appeals.

A. The question presented is an important question of federal bankruptcy law that this Court should resolve

The rejection of executory contracts and unexpired leases is an important part of many bankruptcy proceedings. Rejection permits a bankruptcy trustee or debtor-in-possession to breach contracts that are unfavorable to the debtor, giving the non-breaching parties unsecured claims for contract damages against the bankruptcy estate, which are often only paid in "little tiny Bankruptcy Dollars." See Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 252 (1989). Indeed, many bankruptcy petitions are filed for the very purpose of rejecting unfavorable contracts. See *id.* at 229 (citations omitted). Accordingly, the calculation of rejection damages is an

important issue in bankruptcy law, and whether 11 U.S.C. §§ 365(g)(1) and 502(g) preempt state law whenever state law would consider post-petition events in determining rejection damages is an important question of federal law. Prior to the court of appeals' decision, the answer to this question was clear. Now, the court of appeals' decision threatens to upset the stability that has hitherto existed in this area of bankruptcy law.

Lower courts have routinely followed state law and considered post-petition events in determining rejection damages.⁷ This consistency is not surprising given the well-

⁷ See, e.g., *First Trust of N.Y., N.A. v. Joy Goodwin Trust (In re Ames Dep't Stores, Inc.)*, 209 B.R. 627, 630-31 (S.D.N.Y. 1997) (landlord's rejection damages subject to post-rejection duty to mitigate); *R & O Elevator Co., Inc. v. Harmon*, 93 B.R. 667, 671 (D. Minn. 1988) (citation omitted) (debtor may raise failure to mitigate as a defense to claim for rejection damages); *In re Kmart Corp.*, No. 02 B 02474, 2005 WL 3132460, *4-*5 (Bankr. N.D. Ill. Nov. 1, 2005) (applying Michigan's version of the UCC to calculate product supplier's rejection damages as equal to the contract price after finding that supplier made reasonable post-rejection efforts to sell the product); *In re Mirant Corp.*, 332 B.R. 139, 147 (Bankr. N.D. Tex. 2005) (under Utah law, owner and operator of pipeline had duty to mitigate damages after rejection; value of mitigation deducted from rejection damages); *In re VanZandt*, 326 B.R. 737, 747-48 (Bankr. S.D. Iowa 2004) (applying Iowa law to deduct value of post-rejection mitigation from landlord's rejection damages); *In re Manchester Gas Storage, Inc.*, 309 B.R. 354, 380 (Bankr. N.D. Okla. 2004) ("Rejection damages are measured under traditional state contract law and such damages are subject to mitigation." (citation omitted)); *In re Crown Books Corp.*, 291 B.R. 623, 625-27 (Bankr. D. Del. 2003) (applying terms of lease to include necessary post-rejection reletting expenses and deduct post-rejection mitigation from landlord's

established principle of bankruptcy law that the legal rights of creditors are determined in the first instance by the substantive law that creates the debtor's obligation and that such law applies unless it conflicts with the Bankruptcy Code. *Raleigh*, 530 U.S. at 20 (citations omitted).

State contract law commonly looks to post-breach events to determine the non-breaching party's damages. *See, e.g.,*

rejection damages); *In re Greenville Auto Mall, Inc.*, 278 B.R. 414, 425 (Bankr. N.D. Miss. 2001) (citations omitted) (applying Illinois law to require equipment lessor to mitigate rejection damages post-rejection); *Energy Income Fund, L.P. v. Compression Solutions, Co., L.L.C. (In re Magnolia Gas Co., L.L.C.)*, 255 B.R. 900, 922-23 (Bankr. W.D. Okla. 2000) (equipment lessor's rejection damages equal to contract rate times remaining term of the lease post-rejection); *In re Handy Andy Home Improvement Ctrs., Inc.*, No. 95 B 21655, 1998 WL 603252, *4 (Bankr. N.D. Ill. Sept. 11, 1998) (citations omitted) (applying Illinois law to deduct rents received post-rejection under subsequent lease from landlord's rejection damages); *In re All For a Dollar, Inc.*, 191 B.R. 262, 264-65 (Bankr. D. Mass. 1996) ("Once the damage claim is determined applying state law, the statutory cap of § 502(b)(6) is applied. Postpetition rentals are not to be deducted from the statutory cap, but from the damage claim." (citations omitted)); *In re Iron-Oak Supply Corp.*, 169 B.R. 414, 420 (Bankr. E.D. Cal. 1994) ("[A] landlord's allowable damages are the lower of (1) the statutory cap computed in accordance with the ordinary language of section 502(b)(6) ignoring mitigation or (2) total rejection damages, which take mitigation into account, available under nonbankruptcy law."); *see also Solow v. PPI Enters. (U.S.), Inc. (PPI Enters. (U.S.), Inc.)*, 324 F.3d 197, 208 n.17 (3d Cir. 2003) (noting that landlord has duty to mitigate damages arising from tenant's rejection of lease and that any mitigation offsets the landlord's potential recovery); *In re Bob's Sea Ray Boats, Inc.*, 143 B.R. 229, 231 (Bankr. N.D. 1992) (citation omitted) (same).

cases cited *supra* note 7 (requiring and deducting post-rejection mitigation; including necessary post-rejection reletting expenses; limiting damages to term of lease remaining post-rejection); U.C.C. § 2-708 (2003) (measure of seller's damages for non-acceptance or repudiation is difference between market price at the time and place for tender and the unpaid contract price); U.C.C. § 2-709(b) (2003) (when buyer fails to pay, seller may recover the price "of goods identified to the contract if the seller is unable after reasonable effort to resell them"); U.C.C. § 2-710 (2003) (seller's incidental damages include reasonable expenses "in the transportation, care and custody of goods after the buyer's breach"); U.C.C. § 2-712(2) (2003) (buyer may "cover" and recover from seller "difference between the cost of cover and the contract price"); U.C.C. § 2-713(1) (2003) (measure of buyer's damages for non-delivery or repudiation is "difference between the market price at the time the buyer learned of the breach and the contract price");⁸ U.C.C. § 2-715 (1952) (buyer's incidental and consequential damages arising after seller's breach).⁹

⁸ The time of valuation under U.C.C. § 2-713(1) is important to the purposes of that provision. See U.C.C. § 2-713 cmt. 1 (1952) ("The general baseline adopted by this section uses as a yardstick the market in which the buyer would have obtained cover had he sought that relief."). Since the non-breaching party may only seek cover upon learning of the breach, the time that such party learns of the breach determines the relevant market for determining damages.

⁹ Every state, the District of Columbia, and the Virgin Islands have enacted U.C.C. §§ 2-708, 2-713. 4A RONALD A. ANDERSON, *ANDERSON ON THE UNIFORM COMMERCIAL CODE* §§ 2-708:2, 2-713:2 (3d ed. 1997). Every state (with the exception of

The reasoning of the court of appeals below would require that all of these laws, insofar as they require consideration of post-petition events, be preempted in the determination of rejection damages. The effect of such preemption may be illustrated with two simple hypotheticals. Assume that a party contracts to buy ten widgets at a contract price of \$1.00 per widget. After the buyer takes delivery of and pays for five widgets, the buyer files a bankruptcy petition under Chapter 11. Later, the buyer, as debtor-in-possession, rejects the contract, and the seller finds an alternative buyer who pays \$0.50 each for the five remaining widgets. According to the court of appeals' reasoning, the bankruptcy estate would not receive credit for the seller's mitigation, because the seller's rejection damage claim would be "fixed" on the day before the buyer filed its bankruptcy petition. Thus, the rejection damages claim would be \$5.00, and not \$2.50, notwithstanding the existence of an obvious offset that would arise under the Uniform Commercial Code. *See* U.C.C. § 2-706(1) (2003).

Likewise, assume two parties contract for the sale of ten widgets at the prevailing market price of \$1.00. Before delivering any widgets, the seller files Chapter 11. Between the date of contract execution and the date of the seller's bankruptcy filing, the market price for widgets remained \$1.00. The seller, as debtor-in-possession, delays its decision regarding whether to assume or reject the contract, watching the market price and holding the buyer in limbo. When the seller finally files a motion to reject the contract, the market price for widgets has risen to \$2.00. Following the court of

Louisiana), the District of Columbia, and the Virgin Islands have enacted U.C.C. §§ 2-709, 2-710, 2-712, 2-715. *Id.* at §§ 2-709:2, 2-710:2, 2-712:2, 2-715:2.

appeals' reasoning, the buyer would be entitled to *no damages*. Again, the Uniform Commercial Code provides clear guidance regarding the damages that result from the seller's breach of the agreement — generally, the buyer's damage claim would be \$1.00 per widget, or \$10.00. *See* U.C.C. § 2-713(1) (2003).

The preemption that the court of appeals' decision effects would significantly alter the relationship between state and federal law. *See* Thomas E. Plank, *The Erie Doctrine and Bankruptcy*, 79 NOTRE DAME L. REV. 633, 636 (2004) (“[F]ederal courts in bankruptcy play a significant role — perhaps the most significant of all federal courts — in adjudicating state law issues. The way federal courts in bankruptcy adjudicate these state law issues seriously affects the ultimate allocation of power between states and the federal government.”). Since a sweeping preemption of state contract and commercial law raises serious federalism concerns and presents important questions of federal bankruptcy law, the petition for a writ of certiorari should be granted.

B. The court of appeals' decision conflicts with a decision of the Fifth Circuit

The court of appeals below reasoned that 11 U.S.C. §§ 365(g)(1) and 502(g) require “that damages should be fixed as of the time of the deemed breach, which is ‘immediately before the date of the filing of the petition.’” Pet. App. 9a-10a (quoting § 365(g)(1)). Based on that reasoning, the court of appeals concluded that Section 2-713 of the New York Uniform Commercial Code, which requires that the non-breaching party's damages be the difference between the market value *at the time that it learns of the breach* and the contract price, conflicts with 11 U.S.C.

§§ 365(g)(1) and 502(g). *Id.* at 13a-14a. The court of appeals' decision thus stands for the principle that §§ 365(g)(1) and 502(g) preclude the consideration of post-petition events from the calculation of rejection damages.

The court of appeals' decision conflicts with a decision of the Fifth Circuit Court of Appeals. In *Air Line Pilots Association, International v. Continental Airlines, Inc. (In re Continental Airlines Corp.)*, 901 F.2d 1259 (5th Cir. 1990), the Fifth Circuit considered the proper measure of employees' rejection damages arising from their bankrupt employer's rejection of a collective bargaining agreement ("CBA"). In that case, after halting domestic operations and filing a Chapter 11 bankruptcy petition, the debtor airline rejected the CBA and resumed domestic operations under "Emergency Work Rules" whose terms and conditions differed dramatically from those in the CBA. *Id.* at 1260-61. The debtor's employees responded by calling a strike and filing proofs of claim in the bankruptcy proceeding for rejection damages. *Id.* at 1261. The bankruptcy court disallowed the employees' claims, and the district court affirmed. *Id.*

On appeal, the employees contended that, in addition to accrued wages and benefits, they were entitled under 11 U.S.C. § 502 to future wages and benefits. *In re Cont'l Airlines Corp.*, 901 F.2d at 1264. After noting that the CBA did not guarantee the employees employment, and that, in the absence of rejection, the debtor would have ceased operations within months of the date that it rejected the CBA, the court of appeals concluded that the employees' rejection "damages are to be considered unsecured claims measured by the differences in the rates of pay and fringe benefits set forth in the agreements and the pay and benefits actually received under the Emergency Work Rules." *Id.* at 1265 (emphasis added).

The employees also contended that they were entitled to recover damages for the period that they were on strike. *In re Cont'l Airlines Corp.*, 901 F.2d at 1265. In addressing this contention, the court of appeals began by noting that "the purpose of Section 502(g) is to give the same remedy as would be available had the contract not been rejected." *Id.* The court concluded that "[a]s no damages would have been available to Continental employees for the time when they were on strike outside of bankruptcy, none should be given in this instance." *Id.*

The Fifth Circuit thus considered two post-petition events – the terms of the "Emergency Work Rules" and the employees' strike – in determining the employees' rejection damages. This decision is at odds with the holding of the court of appeals below that 11 U.S.C. §§ 365(g)(1) and 502(g) "fix" rejection damages in such a way as to foreclose consideration of post-petition events regardless of whether such events are relevant under applicable state law.

— C. The court of appeals' decision conflicts in principle with a decision of the First Circuit

In *In re Good Hope Chemical Corporation*, 747 F.2d 806 (1st Cir. 1984), a Texas corporation had contracted with a German manufacturer for the purchase of equipment. *Id.* at 807. After the manufacturer had substantially completed the contract, the Texas corporation filed a voluntary petition for reorganization under Chapter XI of the Bankruptcy Act on October 31, 1975, and rejected the contract on May 9, 1980. *Id.* at 807, 812 & n.7.¹⁰ Although the debtor, manufacturer,

¹⁰ Since the debtor filed its petition on October 31, 1975, *id.* at 807, the Bankruptcy Act of 1898 (as amended) applied instead

and creditors' committee stipulated that the manufacturer's rejection damages claim was the dollar equivalent of 11,055,121 German marks, the parties did not agree upon the date to use for currency conversion. *Id.* at 808 & n.2. The creditors' committee argued that the conversion date should be the date upon which the debtor filed its bankruptcy petition. *Id.* at 808. However, the bankruptcy court accepted the manufacturer's contention that the conversion date should be June 12, 1980, the date that the bankruptcy court allowed the manufacturer's rejection damages claim. *Id.* at 808 & n.5.

On appeal, the First Circuit, construing this Court's currency conversion precedents, first determined "that the rate of exchange in effect on the breach date" applied. *In re Good Hope Chem. Corp.* at 812. The court next considered whether the "relation back rule" of 11 U.S.C. § 103(c) (1976), the predecessor to the current 11 U.S.C. § 365(g)(1), applied to make "the breach date" for currency conversion purposes the date that the debtor filed its bankruptcy petition. In answering this question in the negative, the court noted:

The relation back rule is necessary in bankruptcy because without it a Chapter XI debtor would be required to reject an executory contract immediately upon filing or have its obligation for damages upon rejection during the bankruptcy case treated as an administrative expense entitled to priority This rationale for the operation of [11 U.S.C. § 103(c)]

the current Bankruptcy Code, which came into effect as a result of the Bankruptcy Reform Act of 1978, Pub. L. 95-598, 92 Stat. 2590.

(1976)] has no applicability to the conversion rate issue.

Id. at 812-13. The First Circuit thus recognized that the relation back rule served a particular purpose and did not mandate that the petition date be considered the breach date for all purposes. Although the First Circuit was not presented with the question of whether federal bankruptcy law precluded consideration of post-petition events in determining rejection damages, as opposed to determining exchange rates, the First Circuit's analysis conflicts in principle with the decision of the court of appeals below.

II. THE COURT OF APPEALS' DECISION WAS ERRONEOUS

A. The court of appeals' decision is erroneous in light of the history and purpose of 11 U.S.C. §§ 365(g)(1) and 502(g)

The conceptual origin of §§ 365(g)(1) and 502(g) is this Court's seminal decision in *Central Trust Company of Illinois v. Chicago Auditorium Association*, 240 U.S. 581 (1916). See Brubaker, *supra*, at 2, 5; Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding 'Rejection'*, 59 U. COLO. L. REV. 845, 870 (1988). In that case, the debtor had an executory contract with the Chicago Auditorium Association ("CAA"), according to which the debtor was to pay CAA a monthly rate for the exclusive right to provide transportation and livery services to CAA's hotel. *Chicago Auditorium Ass'n*, 240 U.S. at 585-86. During the term of the contract, an involuntary bankruptcy petition was filed against the debtor. *Id.* When the bankruptcy trustee did not assume the contract with CAA, CAA entered into a new contract with a different counterparty and filed a claim against

the debtor's estate for breach of contract damages. *Id.* In analyzing whether CAA could seek to recover its claim in the bankruptcy proceeding, this Court noted that in *Zavelo v. Reeves*, 227 U.S. 625, 631 (1913), it had "held that the debts provable under § 63a-4 include only such as existed at the time of the filing of the petition." *Chi. Auditorium Ass'n*, 240 U.S. at 592. However, the Court reasoned "that it would be 'an unnecessary and false nicety' to hold that because it was the act of filing the petition that wrought the breach, therefore there was no breach at the time of the petition." *Id.* (quotation omitted). Therefore, the Court concluded "that the intervention of bankruptcy constituted such a breach of the contract in question as entitled [CAA] to prove its claim." *Id.* *Chicago Auditorium Association* is thus the origin of the legal fiction that claims for rejection damages arise prepetition. Brubaker, *supra*, at 6. The purpose of this fiction was clearly to include rejection damages claims in the bankruptcy proceeding and to make such claims subject to discharge despite the fact that the claims did not really exist at the time the petition was filed.

Congress codified the holding of *Chicago Auditorium Association* in the 1938 Chandler Act amendments to the Bankruptcy Act of 1898: "the rejection of an executory contract or unexpired lease, as provided in this Act, shall constitute a breach of such contract or lease as of the date of the filing of the petition initiating the proceeding under this Act." Chandler Act, ch. 575, § 63c, 52 Stat. 840, 873-74 (1938); see Westbrook, *supra*, at 874-75 (quotation omitted). Congress took this action, noting that "[w]hile this a fictional relation back, it is necessary as a mechanical device." S. REP. NO. 75-1916, at 6 (1938).

The legislative history that accompanied the creation of the Bankruptcy Code in 1978 indicates Congress' continuing

intent to codify the holding of *Chicago Auditorium Association*, now in 11 U.S.C. §§ 365(g) and 502(g). The federal reports that accompanied the enactment of 11 U.S.C. § 365(g) stated that “[s]ubsection (g) defines the time as of which a rejection of an executory contract or unexpired lease constitutes a breach of the contract or lease. Generally, the breach is as of the date immediately preceding the date of the petition. *The purpose is to treat rejection claims as prepetition claims.*” S. REP. NO. 95-989, at 60 (1978) (emphasis added); H.R. REP. NO. 95-595, at 349 (1977) (emphasis added). Likewise, the federal reports that accompanied the enactment of 11 U.S.C. 502(g) in 1978 stated that “[s]ubsection (g) gives entities injured by the rejection of an executory contract or unexpired lease, either under Section 365 or under a plan or reorganization, a *prepetition claim for any resulting damages*, and requires that the injured entity be treated as a *prepetition creditor with respect to that claim.*” S. REP. NO. 95-989, at 65 (1978) (emphasis added); H.R. REP. NO. 95-595, at 354 (1977) (emphasis added).

The court of appeals did not consider any of this evidence of the history and purpose of 11 U.S.C. §§ 365(g)(1) and 502(g). Furthermore, the court of appeals construed these provisions in a way that is unsupported by their history and purpose. The history and purpose of 11 U.S.C. §§ 365(g)(1) and 502(g) indicate that these provisions serve an important but limited purpose.¹¹ There is no indication in the history

¹¹ The lower courts in this case failed to heed the sound counsel that “[f]ictions are to be applied in light of the reasons in back of them,” and that, therefore, “[t]he scope of any particular fiction becomes defined only when we know what actuated its author.” LON L. FULLER, *LEGAL FICTIONS* 50-51 (1967).

and purpose of these provisions that they are intended to establish a date certain for the valuation of rejection damages or to preempt state law to the extent that state law would look to post-petition events in the determination of rejection damages. Indeed, as one scholar has noted

The nondebtor contract parties in . . . *American HomePatient* . . . argued that, obviously, "section 502(g) does nothing more than cause a rejection damage claim to be classified as a pre-bankruptcy unsecured claim." The history and purpose of that provision, as well as bankruptcy's traditional pervasive deference to nonbankruptcy state law in assessing the validity and amount of creditors' claims, all indicate emphatically that the nondebtor contract parties were absolutely correct in this argument.

Brubaker, *supra*, at 7 (internal quotation omitted).

B. The court of appeals' decision is otherwise erroneous

The court of appeals rightly sought an interpretation of 11 U.S.C. § 502(g) that would give meaning to both "allowed" and "determined." However, rather than examining how courts have actually applied § 502(g) or considering similar language in other subsections of § 502, the court of appeals relied upon an on-line dictionary to find the meaning of "determine." Pet. App. 9a (quoting Definition of determine – Merriam-Webster Online Dictionary, <http://www.m-w.com/dictionary/determine>).¹² Finding the dictionary

¹² The court of appeals' decision gives no indication that the court was cognizant of the potential limitations of merely relying

definition of “determine” to be “to fix the boundaries of,” the court of appeals concluded that 11 U.S.C. § 502(g) “requires that damages be *fixed* as of a date ‘before the date of the filing of the petition.’” *Id.* (quotation omitted) (emphasis added).¹³ The court of appeals’ interpretation is erroneous for several reasons.

First, under 11 U.S.C. § 502(g), a breach of contract claim arising from rejection is determined “the same as if such claim had arisen *before the date* of the filing of the petition.” 11 U.S.C. § 502(g) (2002).¹⁴ The language of 11 U.S.C. § 502(g) does not provide a date certain from which rejection claims are to be calculated. Instead, the provision

upon dictionary definitions to interpret statutes. *See, e.g., Hibbs v. Winn*, 542 U.S. 88, 116 (2004) (citations omitted) (noting relevance of interpretation of prior statutes and discussing failure to consider alternative definitions and alternative dictionaries); *Olympic Airways v. Husain*, 540 U.S. 644, 663 (2004) (Scalia, J., dissenting) (“Merely pointing to dictionaries that define “event” as an “occurrence” or “[s]omething that happens” . . . hardly resolves the problem; it only reformulates one question . . . into an equivalent one” (citation omitted)); John F. Manning, *The Absurdity Doctrine*, 116 HARV. L. REV. 2387, 2393 (2003) (“[T]he literal or dictionary definitions of words will often fail to account for settled nuances or background conventions that qualify the literal meaning of language and, in particular, of legal language.”).

¹³ Although the same dictionary contains several other definitions for “determine,” *see* Definition of determine – Merriam-Webster Online Dictionary, <http://www.m-w.com/dictionary/determine> (last visited December 27, 2005), the court of appeals did not explain its choice of definition.

¹⁴ The same construction appears in 11 U.S.C. § 502(e)(2), (f), (h), (i).

merely places rejection claims within a particular period, namely the period prior to the filing of the bankruptcy petition.

Second, in addition to its use in 11 U.S.C. § 502(g), the word “determined” also appears in 11 U.S.C. § 502(e)(2).¹⁵ That subsection provides that “[a] claim for reimbursement or contribution of such an entity that becomes *fixed* after the commencement of the case shall be *determined*, and shall be allowed . . . or disallowed, the same as if such claim had become *fixed* before the date of the filing of the petition.” 11 U.S.C. § 502(e)(2) (2002) (emphasis added). Since the claim in § 502(e) has already become “fixed,” “determined” there cannot mean what the court of appeals concluded it means in § 502(g). There is no evident explanation for why Congress would use the same term within one section to mean two different things. Accordingly, since it is a “basic canon of statutory construction that identical terms within an Act bear the same meaning,” *Estate of Cowart v. Nicklos Drilling Co.*, 505 U.S. 469, 479 (1992) (citation omitted), the court of appeals’ interpretation of § 502(g) is quite improbable.

Third, the court of appeals’ interpretation of 11 U.S.C. § 502(g), which precludes consideration of post-petition events in the determination of rejection damages, would undermine long-established legal principles and produce absurd results. It is well settled “that no party suffering loss as the result of a breach of contract is entitled to any damages which could have been avoided if the aggrieved party had acted in a reasonably diligent manner in attempting to lessen

¹⁵ Although “determined” also appears in 11 U.S.C. § 502 (f), (h), (i), these subsections do not assist in understanding the meaning of “determined” in § 502(g).

the losses as a consequence of the breach." 3 MARY ANNE FORAN, WILLISTON ON SALES § 24-13 (4th ed. 1996); see 11 ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS § 1039 (interim ed. 1979); RESTATEMENT (SECOND) OF CONTRACTS § 350(1) (1981). Since the non-breaching party's mitigation of the damages arising from rejection will necessarily occur post-petition, the court of appeals' interpretation of 11 U.S.C. § 502(g) would preclude courts from considering mitigation in determining rejection damages. Thus, for example, if a landlord found a new tenant after the bankruptcy trustee of a debtor tenant had rejected a lease, the court of appeals' interpretation, by "fixing" the damages as of the date immediately before the petition was filed, would not deduct the landlord's gains under the new lease from its rejection damages. Even if the plain meaning of § 502(g) supported the court of appeals' interpretation, which it does not, the plain meaning would have to give way to avoid absurdity. See *Sorrells v. United States*, 287 U.S. 435, 450 (1932) ("To construe statutes so as to avoid absurd or glaringly unjust results, foreign to the legislative purpose, is . . . a traditional and appropriate function of the courts.").

Fourth, the lower courts have consistently considered post-petition events in determining the measure of rejection damages. See cases cited *supra* note 7. Although the court of appeals cited several cases in support of its holding, these cases do not involve the question of whether 11 U.S.C. § 502(g) preempts otherwise applicable state law that would look to post-petition events to determine rejection damages. At most these cases merely state the general principle that

rejection damages are ordinarily determined as of the date before the petition is filed.¹⁶

Fifth, the court of appeals' interpretation of 11 U.S.C. § 502(g) is not the only one that gives "determined" a distinct

¹⁶ See *Sexton v. Dreyfus*, 219 U.S. 339, 343-46 (1911) (secured creditors could not recover post-petition interest); *Addison v. Langston (In re Brints Cotton Mktg., Inc.)*, 737 F.2d 1338, 1342 (5th Cir. 1984) (concluding that, pursuant to 11 U.S.C. § 502(c)(1), the bankruptcy court properly estimated unliquidated claims of cotton sellers when it used the petition date to value the cotton); *Workman v. Harrison*, 282 F.2d 693, 699 (10th Cir. 1960) (project promoter's rejection damages against estate of project financier "limited to the value of his contract at the date the petition on bankruptcy was filed resulting in [financier's] adjudication" (citation omitted)); *Malden Mills Indus., Inc. v. Maroun (In re Malden Mills Indus., Inc.)*, 303 B.R. 688, 702 (B.A.P. 1st Cir. 2004) (landlord's rejection damages "fixe[d] . . . as of the petition date" (citation omitted)); *In re O.P.M. Leasing Servs., Inc.*, 79 B.R. 161, 167 (S.D.N.Y. 1987) (equipment lessee's rejection damages discounted to present value as of the date before the petition was filed); *In re Indep. Am. Real Estate, Inc.*, 146 B.R. 546, 553 (Bankr. N.D. Tex. 1992) ("State law specifies the remedies of a non-breaching party to a contract when the contract is breached, to the extent state law does not contravene the Bankruptcy Code." (citations omitted)); *In re O.P.M. Leasing Serv., Inc.*, 56 B.R. 678, 684, 686 (Bankr. S.D.N.Y. 1986) (equipment lessee's rejection damages discounted to present value as of the date before the petition was filed); *In re Davies*, 27 B.R. 898, 900-01 (Bankr. E.D.N.Y. 1983) ("the court will determine the amount and the validity of the claim as of the date of the breach"; rejecting liquidated damages claim as improper under state law; noting that lessee could have sought damages under Section 2-708 of the New York Uniform Commercial Code under which damages would be "difference between the market price and the unpaid contract price at the time and place of tender" (emphasis added)).

meaning from "allowed." As this Court has noted, rejection damages "must be administered through bankruptcy and receive the priority provided general unsecured creditors." *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 531 (1984) (citing 11 U.S.C. §§ 502(g), 507). Accordingly, whether a claim is "allowed" or "disallowed" determines whether the claimant is entitled to any distribution from the estate. When a claim is "determined" to have arisen determines whether the claim is an unsecured, prepetition claim or a post-petition administrative claim receiving higher priority upon distribution of the estate. It is not necessary to interpret "determined" as establishing a valuation date in order to distinguish it from "allowed."

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

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APPENDIX A

**UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT**

No. 04-5771

October 3, 2005, Filed

IN RE: AMERICAN HOMEPATIENT, INC.,)
ET AL.,)
Debtors.)
-----)
BANK OF MONTREAL, FOR ITSELF)
AND AS AGENT FOR AIMCO CDO SERIES)
2000-A, ET AL.,)
Appellants,)
)
v.)
)
AMERICAN HOMEPATIENT, INC., ET AL.,)
Appellees.)
-----)

**BEFORE: SILER and GIBBONS, Circuit Judges; and
STAFFORD,* District Judge.**

* Hon. William H. Stafford, Senior United States District Judge for the Northern District of Florida, sitting by designation.

ORDER

The court having received a petition for rehearing en banc, and the petition having been circulated not only to the original panel members but also to all other active judges of this court, and no judge of this court having requested a vote on the suggestion for rehearing en banc, the petition for rehearing has been referred to the original panel.

The panel has further reviewed the petition for rehearing and concludes that the issues raised in the petition were fully considered upon the original submission and decision of the case. Accordingly, the petition is denied.

ENTERED BY ORDER OF THE COURT

/s/

Leonard Green, Clerk

APPENDIX B

**UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT**

No. 04-5771

[Filed July 11, 2005]

IN RE: AMERICAN HOMEPATIENT, INC.,)
ET AL.,)
Debtors.)
<hr/>	
BANK OF MONTREAL, FOR ITSELF)
AND AS AGENT FOR AIMCO CDO SERIES)
2000-A, ET AL.,)
Appellants,)
)
v.)
)
AMERICAN HOMEPATIENT, INC., ET AL.,)
Appellees.)

Appeal from the United States District Court
for the Middle District of Tennessee at Nashville
No. 04-00188
Thomas A. Wiseman, Jr., District Judge

BEFORE: SILER and GIBBONS, Circuit Judges; and
STAFFORD,* District Judge.

OPINION

STAFFORD, District Judge. As agent for the senior secured lenders in this bankruptcy case, the appellant, Bank of Montreal, appeals an order affirming the bankruptcy court's determination of the amount of damages resulting from the debtors'/appellees' rejection of an executory contract during Chapter 11 reorganization. We affirm.

I.

Effective May 25, 2001, American HomePatient, Inc. ("AHP"), entered into a credit agreement with certain of its secured lenders, including the Bank of Montreal (collectively, "Lenders"). In connection with the credit agreement, AHP also entered into a warrant agreement ("Warrant Agreement") that called for AHP to issue two series of warrants which, when exercised, would permit the warrant holders to purchase 3,265,315 shares (or 19.99%) of AHP common stock at an exercise price of \$0.01 per share. The Warrant Agreement defined "Warrant Holder" to mean "each Lender and thereafter each Person to whom a Lender or other Warrant Holder may transfer any Warrants." J.A. at 816.

On July 31, 2002, AHP and twenty-four of its subsidiaries and affiliates (collectively, "Debtors") filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code. The United States Bankruptcy Court for the Middle District

* Hon. William H. Stafford, Senior United States District Judge for the Northern District of Florida, sitting by designation.

of Tennessee ("Bankruptcy Court") confirmed Debtors' Second Amended Joint Reorganization Plan ("Plan") by order entered May 27, 2003. The Plan became effective on July 1, 2003.

Under the Plan, Debtors were authorized to reject executory contracts within ten (10) days after the Plan's July 1, 2003, effective date. On July 11, 2003, Debtors filed a notice of rejection and a motion for an order authorizing Debtors to reject the Warrant Agreement and to quantify the amount of any damages resulting from the rejection of that Warrant Agreement. Debtors argued that the Warrant Holders' damage claim was \$0.00 or, alternatively, at most \$881,635.05.

The Bank of Montreal (the "Bank"), as the agent for Lenders, filed an objection to Debtors' motion on behalf of Lenders. Among other things, the Bank argued that the Warrant Agreement was not an executory contract subject to rejection. The Bank also took issue with the method used by Debtors to calculate a rejection damage claim.

On November 20-21, 2003, the Bankruptcy Court held a hearing to consider Debtor's motion and the Bank's objection to the motion. In a memorandum decision entered December 12, 2003, the Bankruptcy Court overruled the Bank's objection to Debtors' motion to reject the Warrant Agreement and found the damages stemming from rejection to be \$846,369.85. In determining the amount of damages, the Bankruptcy Court relied on sections 365(g)(1) and 502(g) of the Bankruptcy Code to set a rejection date of July 30, 2002, the day immediately prior to the filing of Debtors' bankruptcy petition. In essence, the Bankruptcy Court found that damages should be allowed "in the amount that the Lenders would have recovered as of the time the petition was filed." J.A. at

338. After hearing from each of the parties' experts as to how rejection damages should be calculated, the Bankruptcy Court--consistent with Debtor's expert's testimony--set the price per warrant at \$0.02692 (an estimate of the fair market value of shares on the date before the petition was filed), subtracted the warrant exercise price of \$0.01 per warrant, then multiplied the difference by the number of warrants (3,265,315) held by Lenders, thus arriving at a damage figure of \$846,369.85. An order commemorating the Bankruptcy Court's memorandum decision was entered December 31, 2003.

At the hearing, the experts presented different methodologies for determining damages, resulting in differing estimates as to the amount of those damages. Both experts, however, testified that their rejection damage calculations were based on a pre-petition, July 30, 2002, valuation date. When specifically asked about his selection of a valuation date, the Bank's expert explained that he used the pre-petition date because that was the date provided to him by the Bank's counsel. No evidence was offered at the hearing to support a damages calculation as of any date other than July 30, 2002, the day immediately prior to the filing of Debtors' bankruptcy petition.

After its motion to alter or amend the Bankruptcy Court's December 12, 2003, memorandum decision and December 31, 2003, order was denied as to all substantive issues, the Bank appealed to the United States District Court for the Middle District of Tennessee. On May 21, 2004, the District Court entered a memorandum decision and order affirming the decision of the Bankruptcy Court. The Bank then filed its timely notice of appeal in this case.

II.

In reviewing a bankruptcy decision appealed to the district court, "we review directly the decision of the bankruptcy court. We accord no deference to the district court's decision; we apply the clearly erroneous standard to the bankruptcy court's findings of fact, and we review de novo the bankruptcy court's conclusions of law." *Brady-Morris v. Schilling (In re Kenneth Allen Knight Trust)*, 303 F.3d 671, 676 (6th Cir. 2002).

III.

A.

The Bank contends that the Bankruptcy Court erred as a matter of law when it used the pre-petition date as the date from which rejection damages were calculated. While conceding that the breach and the resulting contract damage claim are deemed to have arisen on the day before the filing of the bankruptcy case, the Bank maintains that neither section 365(g)(1) nor section 502(g) of the Bankruptcy Code requires that the *amount* of rejection damages be fixed as of that date. According to the Bank, section 502(g) does nothing more than cause a rejection damage claim to be classified as a pre-bankruptcy unsecured claim.

The Bank, for the first time, raised the issue regarding the valuation date in its pre-trial memorandum filed the morning of the Bankruptcy Court hearing, November 20, 2003. At that time, the Bank suggested that damages should be calculated *not* from July 30, 2002 (the day before the filing of the petition), but from July 11, 2003, the date Debtors filed both a notice of rejection as well as a motion for order authorizing Debtors to reject the Warrant Agreement. While the Bank

offered no expert testimony at the hearing about what damages would be if a July 11, 2003, valuation date were used, the Bank nonetheless argued in its pre-trial memorandum that damages should be calculated by taking the price of shares on the date Lenders learned of the breach (i.e., July 11, 2003), subtracting the warrant exercise price of \$0.01 per warrant, then multiplying the difference by the number of warrants held by Lenders, resulting in damages of \$6,987,774.10. The Bankruptcy Court rejected the Bank's argument.

Bankruptcy Code section 365(g) provides that, upon rejection of an executory contract, the time of breach by the debtor is fixed as of the day "immediately before the date of the filing of the petition." 11 U.S.C. § 365(g)(1). The effect of the breach is to allow the party injured by the rejection to seek allowance of its resulting claim as a pre-petition unsecured claim. Pursuant to section 365(g)(1), the Bankruptcy Court found that Debtor's breach of the Warrant Agreement occurred on July 30, 2002. The Bank does not contest this finding.

Section 502(g) of the Bankruptcy Code provides that "[a] claim arising from the rejection, under section 365 of this title..., of an executory contract or unexpired lease of the debtor that has not been assumed *shall be determined, and shall be allowed* under subsection (a), (b), or (c) of this section, or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition." 11 U.S.C. § 502(g) (emphasis added). The language of section 502(g)--providing that a claim for rejection damages "shall be determined, and shall be allowed...as if such claim had arisen before the date of the filing of the petition"--seems clear. *See Henry Ford Health Sys. v. Shalala*, 233 F.3d 907, 910 (6th Cir.2000) (explaining

that a court must “read statutes and regulations with an eye to their straightforward and commonsense meanings”). Webster defines the word “determine” to mean, among other things, “to fix the boundaries of.” *Merriam-Webster Online Dictionary*, at <http://www.m-w.com>. Webster defines the word “allow” to mean “permit.” *Id.* If, as the Bank argues, section 502(g) does nothing more than cause a rejection damage claim to be classified as a pre-bankruptcy unsecured claim, use of the two words, “determine” and “allow,” would be unnecessary. Indeed, the word “allow” would be sufficient to “permit” a rejection damage claim to be classified as a pre-bankruptcy unsecured claim, and the word “determine” would serve no apparent purpose whatever.

Congress, however, chose to include the word “determine” in section 502(g), and we must give effect to that word. See *Duncan v. Walker*, 533 U.S. 167, 174 (2001) (noting that it is the court’s duty “‘to give effect, if possible, to every clause and word of a statute’”) (quoting *United States v. Menasche*, 348 U.S. 528, 538-39 (1955) (quoting *Montclair v. Ramsdell*, 107 U.S. 147, 152 (1883))); *Market Co. v. Hoffman*, 101 U.S. 112, 115 (1879) (explaining that “[i]t is a cardinal rule of statutory construction that significance and effect shall, if possible, be accorded to every word”); *Walker v. Bain*, 257 F.3d 660, 667 (6th Cir. 2001) (explaining that “[e]very word in the statute is presumed to have meaning, and we must give effect to all the words to avoid an interpretation which would render words superfluous or redundant”), *cert. denied*, 535 U.S. 1095 (2002). Reading the word “determine” to mean “fix the boundaries of,” we conclude that section 502(g) requires that damages be fixed as of a date “before the date of the filing of the petition.” 11 U.S.C. § 502(g). Indeed, consistent with section 365(g)(1), we conclude that damages should be fixed as of the time of

the deemed breach, which is "immediately before the date of the filing of the petition." 11 U.S.C. § 365(g)(1).

Contrary to the Bank's argument, courts appear to be in general agreement that, when an executory contract is rejected, damages are fixed at or immediately before the date of the filing of the petition, not at some later time when an executory contract is, in fact, rejected. For example, in *Addison v. Langston (In re Brints Cotton Mktg., Inc.)*, 737 F.2d 1338, 1341-42 (5th Cir. 1984), the Fifth Circuit affirmed the bankruptcy court's decision to fix damages arising from the debtor's rejection of cotton call contracts based upon the market value of cotton at the time the debtor filed his bankruptcy petition. The creditors in *Brints* had argued that state law gave them the right to fix a reasonable price on their contracts by calling the contracts at any time after the debtor breached the contracts. *Id.* at 1341. In rejecting the creditors' argument, the Fifth Circuit concluded that state law did not trump the bankruptcy court's Code-granted power to fix rejection damages at the time the bankruptcy petition was filed. Cited in support of the Fifth Circuit's decision was *Sexton v. Dreyfus*, 219 U.S. 339 (1911), a bankruptcy case wherein the United States Supreme Court "upheld the fixing of the creditor's rights as of the date of filing the bankruptcy petition, noting the historical fiction that such date 'simply fixes the moment when the affairs of the bankrupt are supposed to be wound up' as if 'the whole matter could be settled in a day.'" *Brints*, 737 F.2d at 1342 (quoting *Sexton*, 219 U.S. at 344); see also *Workman v. Harrison*, 282 F.2d 693, 699 (10th Cir. 1960) (limiting the amount of rejection damages to the value of the executory investment contract on the date the petition was filed).

In *In re Independent American Real Estate, Inc.*, 146 B.R. 546 (Bankr. N.D. Tex. 1992), the bankruptcy court explained

that, when an executory contract is rejected, the amount and validity of a claim for damages is determined as of the date of the breach in accordance with state law, "to the extent state law does not contravene the Bankruptcy Code." *Id.* at 553. In *In re Davies*, 27 B.R. 898 (Bankr. E.D.N.Y. 1983), the bankruptcy court similarly explained as follows:

Under the Code, a rejection gives rise to a legal fiction that a breach of the contract occurred immediately prior to the filing of the petition. 11 U.S.C. Section 365(g)(1). Thus, a claim is allowable for those damages resulting from the breach, *and the court will determine the amount and the validity of the claim as of the date of the breach.*

Id. at 900 (emphasis added); *see also Malden Mills Indus., Inc. v. Maroun (In re Malden Mills Indus., Inc.)*, 303 B.R. 688, 702 (Bankr. 1st Cir. 2004) (stating that, "[u]nder [section 502(g) of] the statute, postpetition rejection fixes the liability of the debtor and, therefore, the recovery of the creditor, as of the petition date"); *In re O.P.M. Leasing Services, Inc.*, 79 B.R. 161, 167 (S.D.N.Y. 1987) (explaining that, when an executory contract is rejected, the claim for damages is fixed as of the petition date, meaning that damages must be discounted to the present value as of the petition date); *In re O.P.M. Leasing Services, Inc.*, 56 B.R. 678, 684 (S.D.N.Y. Bkrtcy. 1986) (stating that "the Code provides a clear directive that whenever general unsecured claims are incurred, whether pre- or postpetition, they are calculated for damage assessment purposes as occurring as of the date the petition was filed").

The Bank cites only two cases in support of its argument that section 502(g) does not fix the date for calculating the amount of rejection damages. *In re Good Hope Chem. Corp.*,

747 F.2d 806 (1st Cir. 1984), *cert. denied*, 471 U.S. 1102 (1985); *In re James R. Corbitt Co.*, 48 B.R. 937 (Bankr. E.D. Va. 1985). Neither case is persuasive. In *In re James R. Corbitt Co.*, 48 B.R. at 942 n.7, the court stated in a footnote, in *dicta*, that a date other than the deemed breach date might be used for purposes of computing the amount of damages "in proper circumstances." The court did not explain what might constitute "proper circumstances." In *In re Good Hope*, the First Circuit held that the actual date upon which an executory contract was rejected, and not the pre-petition "deemed" date of breach, controlled with respect to determining the appropriate exchange rate to be used for the purpose of converting damages, computed in German marks, into a dollar judgment. 747 F.2d at 813. Other than noting that the parties had stipulated to the amount of damages (DM11, 055,121) incurred by the creditor upon the debtor's deemed breach of the contract, the court did not address the issue of when or how damages are to be fixed in the event of a contract rejection. Because it is anything but apparent that the First Circuit's rule regarding selection of an exchange rate should control the section 502(g) "determination" of the Bank's rejection damages claim in this case, the Bank's suggestion that the reasoning in *Good Hope* applies here is not persuasive.

Because the language of the statute as well as the caselaw supports the Bankruptcy Court's decision to value damages as of the date immediately before the date of the filing of the petition, and because *all* of the testimony presented to the Bankruptcy Court regarding the calculation of damages was based on that pre-petition valuation date, the Bank's assertion of error in this regard is not well-taken.

B.

The Bank argues that contract rejection damages must be determined under state law, in this case the law of New York, and not the Bankruptcy Code. While we agree that, as a general rule, damages caused by the rejection of an executory contract are determined under state law, we reject the Bank's argument that the relevant date for calculating Lenders' rejection damages is the date Lenders learned of Debtors' breach.¹

It is well-established that a bankruptcy court is entitled, if authorized by the federal Bankruptcy Code, to determine how and what claims are allowable for bankruptcy purposes. *See, e.g., Raleigh v. Illinois Dep't of Revenue*, 530 U.S. 15, 20 (2000) (explaining that "[c]reditors' entitlements in bankruptcy arise in the first instance from the underlying substantive law creating the debtor's obligation, subject to any qualifying or contrary provisions of the Bankruptcy Code"); *Ohio v. Collins (In re Madeline Marie Nursing Homes)*, 694 F.2d 433, 436-37 (6th Cir. 1982) (recognizing that "the bankruptcy courts, as courts of the United States, have power to supercede state law where it conflicts with the federal bankruptcy law which the court is primarily bound to enforce"). Resort to state law is appropriate and/or necessary when a gap exists in federal bankruptcy law. As the District Court noted, courts "will look to state law to fill in what federal bankruptcy law leaves out regarding such issues as

¹ Under New York law, "the measure of damages for non-delivery or repudiation by the seller is the difference between the market price at the time when the buyer learned of the breach and the contract price together with any incidental and consequential damages provided." N.Y.U.C.C. Law § 2-713.

whether money damages can be recovered at all, the amount of damages, and how issues of bad faith affect the amount of damages." J.A. at 1037.

As noted above, the Bankruptcy Code specifically fixes the date of breach for rejection damages purposes as the date immediately before the date of the filing of a bankruptcy petition. 11 U.S.C. § 365(g)(1). It also specifically provides that any claim arising from a rejection shall be "determined" as if such claim had arisen before the date of the filing of the bankruptcy petition. 11 U.S.C. § 502(g). As these specific provisions leave no "gap" and, therefore, control any conflicting provisions of state law, the Bankruptcy Court did not err when it relied on the July 30, 2002, pre-petition date as the valuation date. The Bank's arguments to the contrary are without merit.

C.

The Bank contends that the Bankruptcy Court erred when it adopted Debtors' expert's opinion as to damages. The Bank bases this argument on its contention that the expert ignored the relevant valuation date under New York law. Having already rejected the Bank's arguments with regard to the valuation date and the application of New York law, we reject this argument as well.

IV.

Because we find no error on the part of the Bankruptcy Court, we AFFIRM.

APPENDIX C

**UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE,
NASHVILLE DIVISION**

Case No. 3:04-0188

[Filed May 21, 2004]

<hr/> BANK OF MONTREAL, et al.,)
Appellant,)
)
v.)
)
AMERICAN HOMEPATIENT, INC., et al,)
Appellee,)
<hr/>)
IN RE: AMERICAN HOMEPATIENT,)
INC., et al)
<hr/>)

**On Appeal From
United States Bankruptcy Court
for the Middle District of Tennessee
Bankr. Case No. 302-08915
Honorable George C. Paine, II**

**Thomas A. Wiseman, Jr., Senior U.S. District Judge for the
Middle District of Tennessee.**

MEMORANDUM**I. INTRODUCTION**

Before the Court is an appeal of the Middle District of Tennessee Bankruptcy Court's ruling, which determined the amount of the Bank of Montreal's¹ ("Agent") damages claim resulting from American Home Patient's² ("Debtor") rejection of an executory contract during a Chapter 11 Reorganization Plan. In its December 11, 2003 Memorandum Opinion, the Bankruptcy Court determined that the Warrant Agreement between the Debtor and the Warrant Holders/Lenders, who are represented by the Agent, was an executory contract and that the resulting damages stemming from the rejection of the agreement were \$846,369.85. (Bankr. Doc. No. 1990, p. 18). Bank of Montreal appealed, arguing that the Bankruptcy Court erred in determining that the Warrant Holders' Damages claim was worth only \$846,369.85. Bank of Montreal filed a Brief in support of its position (Doc. No. 4) to which the Debtor filed a Response (Doc. No. 5), which was followed in turn by a Reply by the Bank (Doc. No. 6). After a careful review of the Record and the filings, the Court **AFFIRMS** the Bankruptcy Court's decision for the reasons set out below.

II. FACTS:

On July 31, 2002, American HomePatient and twenty four

¹ The party titled Bank of Montreal is the Agent for a group of senior secured lenders who extended credit to American Home Patient, Inc.

² The party titled American HomePatient, Inc. represents a Delaware corporation, its subsidiaries and affiliates.

of its subsidiaries filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code. Under the Reorganization Plan, the Debtor was authorized to assume or reject executory contracts. On July 11, 2003, the Debtor moved to reject an option-like Warrant Agreement in which Warrant Holders could purchase 3,365,315 shares, or 19.99%, of American HomePatient stock. The Warrant Agreement, which was entered into in connection with a Credit Agreement, defined Warrant Holders as "each Lender and thereafter each Person to whom a Lender or other Warrant Holder may transfer any Warrants." (Warrant Agreement, p. 5).

The Agent, on behalf of the Lenders, filed an Objection to Debtor's Motion for Order Authorizing Debtor to Reject Warrant Agreement. In their Objection, the Agent argued, as they do in their current Appeal, that the damages arising from the rejection of an executory contract should be determined by state law, in this case by New York law. The Agent applies New York law to argue that the rejection of the Warrant Agreement occurred when the Warrant Holders learned of the Debtor's intention to reject the Warrant. The Debtor responds that the Bankruptcy Code treats the rejection as occurring the day before the Petition was filed.³

³ As will become clear, determining the timing of the warrant agreement's rejection is a crucial question that is linked to the issue of valuation of the warrants which is linked to the issue of rejection damages due the Lenders. Because the price of AHP shares rose sharply from the date of the petition filing to the date the Lenders allegedly learned of the Debtor's intention to reject the Warrant, the estimated value of the warrants varies significantly depending on which date is chosen as the date of rejection.

On November 20-21, 2003, the Bankruptcy Court held a hearing to consider the Debtor's Motion and the Agent's Objection. In a Memorandum Decision, the Bankruptcy Court granted the Debtor's Motion seeking authorization to reject the Agreement. The Court did not specifically address the Agent's argument for determining damages under New York law, but it implicitly rejected that argument by relying on §§ 365 (g)(1) and 502 (g) of the Bankruptcy Code to set the rejection date as June 30, 2003, the day immediately prior to the petition filing. Relying on these sections of the Bankruptcy Code and on the relevant case law, the Court found "that damages stemming from the rejection should be determined as if such claim had arisen before the date of filing the petition." (Memorandum Decision, p. 13). As a result, the Court found that the claim should be allowed "in the amount the Lenders would have recovered as of the time the petition was filed." (*Id.*).

The Court then heard testimony from each of the parties' experts as to how rejection damages should be calculated. After evaluating the experts' testimony, the Court found the Debtor's expert to be more persuasive than the Lenders' expert on the issue of the correct value the warrants held on the day before the petition was filed. Accordingly, the Court set the price per warrant at \$.02692, subtracted the warrant exercise price of \$0.01 per warrant, and then multiplied the difference by the 3.3 million odd warrants held by the Lenders to arrive at \$846,369.85 in rejection damages. Following the entry of an Order incorporating the Memorandum Decision's findings, the Agent filed a Motion to Alter or Amend the Order, which the Bankruptcy Court denied as to all material issues raised by the Agent. This appeal followed.

III. STANDARD OF REVIEW

Under Bankruptcy Rule 8013, this Court will not set aside a Bankruptcy Court's findings of fact unless the Court finds them to be "clearly erroneous." A finding of fact is clearly erroneous when "although there is evidence to support the finding, the reviewing court on the entire evidence is left with a definite and firm conviction that a mistake has been committed." *In re Scott*, 1999 WL 644380 at *3 (6th Cir. Aug. 3, 1999). The bankruptcy judge's conclusions of law are reviewed de novo. *See Woolum v. Bank One, Lexington, N.A.*, 979 F.2d 71, 75 (6th Cir. 1992); *see also In re Creekstone Apartments Assocs., L.P.*, 1995 WL 588904 at *3 (M.D.Tenn. 1995).

III. DISCUSSION

A. The Date of Breach

Section 365(g)(1) provides as follows:

. . . the rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease--

(1) if such contract or lease has not been assumed under this section or under a plan confirmed under chapter 9, 11, 12, or 13 of this title, immediately before the date of the filing of the petition.

11 U.S.C. § 365(g)(1). As a complement to § 365(g)(1), § 502(g) states that "a claim arising from the rejection . . . of an executory contract . . . of the debtor that has not been assumed shall be determined . . . the same as if such claim had arisen before the date of the filing of the petition." 11

U.S.C. § 502(g). Sixth Circuit Bankruptcy and District Courts interpreting §§ 365(g)(1) and 502(g) all agree that the appropriate date for determining damages stemming from rejection of an executory contract is the day before the petition was filed. *In r.e. U.S. Truck Co., Inc.*, 89 B.R. 618, 623 (E.D. Mich. 1988) (stating that rejection of an executory contract is treated as a breach that is "held to have occurred immediately prior to the filing of the petition in bankruptcy"); *In r.e. Steiner*, 50 B.R. 181, 184 (Bankr. N.D. Ohio 1985) ("When a debtor rejects an executory contract, it is deemed to constitute a breach of the contract which occurs immediately prior to the filing of the petition . . . [and the non-breaching party's] claim arises from the damages which are incurred as a result of a rejection of the lease as of that time."); *Acme Precision Building, Ltd. v. Dayton Forging & Heat Treating, Inc.*, 23 B.R. 79, 84 (Bankr. S.D. Ohio 1982) ("The rejection of the unexpired lease constitutes a breach of the lease contract as of the date immediately preceding the filing of the petition in Chapter 11"); *In r.e. Solon Automated Servs., Inc. v. Georgetown of Kettering, Ltd.*, 22 B.R. 312, 316 (Bankr. S.D. Ohio 1982) ("Postpetition rejection of a lease . . . is statutorily construed as constituting a breach giving rise to damages 'immediately before the date of the petition'"). Sixth Circuit courts are by no means alone in finding that §§ 365(g)(1) and 502 (g) require the court to use the day prior to the petition filing as the relevant date for determining the value of a damages that arise after a contract has been rejected. *Workman v. Harrison*, 282 F.2d 693, 699 (10th Cir.1960) (stating that claim arising from the rejection of an executory contract "is limited to the value of . . . [the] contract at the date the petition in bankruptcy was filed"); *In re O.P.M. Leasing Servs., Inc.* 79 B.R. 161, 164 (S.D.N.Y.,1987) ("[T]he statutory framework provides for the allowance of a claim arising from the rejection of an unexpired lease in that amount which would be recoverable

by the non-breaching party as of the time the petition was filed"); *In r.e. O.P.M. Leasing Servs., Inc.*, 56 B.R. 678 (Bankr. S.D. N. Y. 1986) ("The Code provides a clear directive that whenever general unsecured claims are incurred, whether pre- or postpetition, they are calculated for damage assessment purposes as occurring as of the date the petition was filed").

Despite this seemingly clear area of the law, the Agent advances two major arguments to support its conclusion that the Bankruptcy Court erred in determining that the last date for purposes of considering damages was June 30, 2002. First, the Agent argues that because the Debtor can pay the Lenders the entire amount of damages they seek without diminishing payments to other creditors, the Lenders are entitled to use the date they learned of the breach as the determinative date for valuing the warrants. The Debtor's ability to pay all its creditors, the Agent argues, does not implicate the economic policy behind treating contract rejection as pre-bankruptcy unsecured claims rather than post-bankruptcy administrative claims. Second, the Agent relies on several authorities that require property interests to be determined under state law, even in the context of a bankruptcy proceeding, to suggest that contract rejection damages in this case must be calculated under NY law, not the Bankruptcy Code. The Debtor responds that federal bankruptcy law preempts any state law regarding property interests, especially in this case where there are bankruptcy provisions that specifically relate to contract rejection damages.

The Agent's suggestion that the Debtor's ability to pay the Lenders' requested damages in full is a non-starter for purposes of determining the issue before this Court. First, the Agent cites no authority to support the proposition that a

debtor's ability to pay the entire amount of damages a creditor seeks entitles a creditor to such payment. Moreover, accepting the Agent's argument that the Lenders should be paid in excess of \$6 million in damages because the Debtor has the means to do so would place the Lenders' interests of being compensated for a breach ahead of the Debtor's interests in rehabilitating itself. As one court put it, "the general theme of Section 365 is that the other party to an executory agreement has no protectable interest that offsets the bankruptcy interest of dispensing with burdensome or inconsequential property." *In re White Motor Corp.*, 44 B.R. 563, 568-69 (Bankr. N.D. Ohio 1984).

Next, the Agent cites to Sixth Circuit authority to support his argument that even in bankruptcy proceedings, state law should be used to determine contract rejection damages. After reviewing the relevant case law in this circuit and in others, the Court agrees with the Agent that the damages for contract rejection as a general matter are determined under state law. *In re Madeline Marie Nursing Homes*, 694 F.2d 433 (6th Cir. 1982) (stating that state law should be the basis for determining the underlying obligations of a claim arising out of breach of contract); *In re Handy Andy Home Improvement Centers, Inc.*, 1998 WL 603252, *4 (Bkrcty.N.D.Ill.1998) (stating that landlord's claim for damages resulting from debtor's contract rejection is determined by state law); *In re Besade*, 76 B.R. 845, 847 (Bkrcty.M.D.Fla.,1987) (stating that the measure of contract rejection damages is a question of state law). However, when these courts state that the contract rejection damages are determined under state law, they mean that they will look to state law to fill in what federal bankruptcy law leaves out regarding such issues as whether money damages can be recovered at all, the amount of damages, and how issues of bad faith affect the amount of

damages.⁴ See *In re Madeline*, 694 F.2d at 439 n.7 (stating that the existence and amount of the bankrupt's liabilities, though determined by the bankruptcy court in allowing or disallowing claims, will inevitably be determined by nonbankruptcy, usually state law) (citing Countryman, *The Use of State Law in Bankruptcy Cases* (Part 1), 47 N.Y.U.L.Rev. 407, 412(1972)); *In re Handy Andy*, 1998 WL 603252 at *4 (resorting to Illinois law to determine that damages consist of the rents owed plus costs incurred in obtaining and maintaining a mitigating lease less a credit for rents obtained under a mitigating lease); *Besade*, 76 B.R. at 847 (determining that debtor's actions amounted to bad faith and that under Florida law he was therefore liable for full compensatory damages). Importantly, these cases do not dispute the rule found in §§ 365(g)(1) and § 502(g) that a contract is breached, for purposes of considering claims for rejected contracts, as of the date immediately prior to filing the petition. In summary, these courts seem to accept that bankruptcy law establishes the parameters for allowing contract rejection claims—for example, that they be treated as unsecured pre-petition claims and that breach is deemed to occur immediately prior to the petition date--and that state law fills in the gaps--notably, by providing guidance as to whether there is any merit to the damages claims and how much they are worth. See *In re Madeline*, 694 F.2d at 439 f.7 (stating that although federal law governs the disposition of claims to the debtor's assets, state law clearly governs the creation and definition of those claims) (citing Note, *Bankruptcy and the Limits of Federal Jurisdiction*, 95 Harv. L. Rev. 703, 705 (1982)).

⁴ Clearly, the Bankruptcy Code did not leave out the important question of when, in the context of a rejected contract in bankruptcy, a breach is deemed to occur. See 11 U.S.C. § 502(g).

The Agent argues that New York law applies and establishes that the relevant date for determining the Lenders' damages is the date the Lenders learned of the Debtor's breach.⁵ Essentially, the Agent is asking the Court to look forward to events occurring after the petition was filed rather than backward to the date immediately prior to the petition filing. However, it is not necessary to resort to New York law to determine this issue since the answer is in § 502(g) of the Bankruptcy Code: "a claim arising from the rejection . . . of an executory contract . . . of the debtor that has not been assumed shall be determined . . . the same as if such claim had arisen before the date of the filing of the petition." 11 U.S.C. § 502(g). Moreover, to the extent that New York law does apply, the Court finds that it conflicts with § 502(g) of the Bankruptcy Code and that the state provision must yield to the superceding federal law. *In re Madeline*, 694 F.2d at 436-37 (stating that bankruptcy courts have power to supercede state law where it conflicts with the federal bankruptcy law).

⁵ § 2-711 states in pertinent part that:

. . . the measure of damages for non-delivery or repudiation by the seller is the difference between the market price at the time when the buyer learned of the breach and the contract price together with any incidental and consequential damages provided . . .

B. Expert Opinion on Valuation of the Lenders' Damages Claim

In addition to alleging error with respect to the date used for assessing damages, the Agent also argues that the Bankruptcy Court erred by adopting the testimony of the Debtor's expert on the value of the Lenders' damages claim. The Bankruptcy Court heard testimony from the Debtor's and the Lenders' experts and concluded that while the Lenders' expert was credible and knowledgeable, "his expert report was less helpful to assist the court in the damages calculation" in part because his approach "used ex-ante procedure whereby he considered knowledge and information after July 30, 2002 to achieve an accurate estimate of the value of the warrants as of [the] day prior to the petition." (Memorandum Opinion, p. 16-17). The Court found the "snap-shot" analysis provided by the Debtor's expert, in which he used the average price of AHP stock 30 days prior to June 30, 2002 as a baseline, to be "more persuasive, and helpful in the court's analysis." (*Id.*).

As the Bankruptcy Court stated, "[when] weighing conflicting appraisal testimony, courts generally evaluate a number of factors, including: ... the appraiser's . . . manner of conducting the appraisal, testimony on direct examination, testimony on cross-examination, and overall ability to substantiate the basis for the valuation presented.'" *In re American HomePatient, Inc.*, 298 B.R. 152, 173 (Bkrtcy.M.D.Tenn. 2003) (quoting *In re Smith*, 267 B.R. 568, 572-573 (Bankr.S.D.Ohio 2001). As for the proper standard of review, valuation is a mixed question of law and fact, the factual premises being subject to review on a clearly erroneous standard, and the legal conclusion being subject to *de novo* review. *In re Clark Pipe & Supply Co., Inc.*, 893 F.2d 693, 697-98 (5th Cir. 1990).

The Court finds that it was not reversible error for the Bankruptcy Court to credit the Debtor's expert over the Lenders' expert considering that the Lenders' expert relied on post-petition information in valuing the warrants and the Debtor's expert did not. In the Court's opinion, the decision by the Debtor's expert to use only pre-petition stock prices in valuing the warrants is consistent with the spirit of § 502(g) because it restricts the rejection claim to the pre-petition universe, as directed by § 502. Furthermore, the use by the Debtor's expert of a valuation method that is common in the industry reduces the likelihood that the court below erred in accepting the valuation.

IV. CONCLUSION

Having weighed the parties' arguments and consulted the Bankruptcy Code and controlling authorities, the Court finds that the language of Sections 365(g)(1) and 502(g) of the Bankruptcy Code, as well as judicial interpretation of these provisions, support the Bankruptcy Court's decision to determine the rejection damages as of July 30, 2002. Similarly, the Court finds that it was not error for the Bankruptcy Court to adopt the testimony of the Debtor's expert with respect to valuation. Accordingly, the Bankruptcy Court's Order is AFFIRMED.

Dated: 5/21/04

/s/

Thomas A. Wiseman, Jr.
Senior U.S. District Judge
for the Middle District
of Tennessee

APPENDIX D

**IN THE UNITED STATES BANKRUPTCY COURT
FOR THE MIDDLE DISTRICT OF TENNESSEE**

**Case No. 302-08915
Chapter 11 (Substantively Consolidated)**

[Filed December 12, 2003]

In Re:)
)
AMERICAN HOMEPATIENT,)
INC., ET AL.,)
Debtor.)
)

Honorable George C. Paine, II

MEMORANDUM

This matter is before the court on the debtor's motion for an "Order Authorizing Debtors to Reject Warrant Agreement." For the reasons hereinafter cited, the court grants the debtor's motion and finds the damages stemming from rejection are \$846,369.85. The debtor shall prepare an Order consistent with this Memorandum within ten (10) days of entry of this Opinion.

Factual Background

The Warrant Agreement provides that the debtor is required to issue two series of warrants which, in aggregate, are exercisable to purchase up to 3,265,315 share of the common stock, \$0.01 par value, constituting 19.9% of the company's outstanding shares of common stock. The warrant holders must surrender the warrant certificate to the company with payment, and the debtor must thereafter issue and deliver the appropriate number of shares.

According to the debtor, under Section 8.1 of the confirmed Second Joint Amended Plan of Reorganization (the "Plan"), "[a]ll executory contracts with the Debtors that have not, as of ten (10) days following the Effective Date, been specifically rejected shall be deemed contracts that the Debtors intend to assume, provided the Debtors agree to pay any Allowed Cure Claim." Because the debtor contends that the Warrant Agreement is an executory contract, the debtor moved to reject the Warrant Agreement in exercise of its' business judgment as most beneficial to the estate.

The Lenders, however, contend that rejection of the Warrant Agreement cannot occur for at least three reasons: (1) the express terms of the Plan prevent such ("Record Holders of Interest in AHP Common Stock shall Retain their Interests." Interest is defined in the Plan as "the equity interests in the AHP Common Stock or any options, warrants or rights to purchase or acquire such stock."); (2) the debtor is estopped from rejecting the Warrant Agreement because the debtor failed to list the Warrant Agreement in Schedule G or Amended Schedule G which listed all "Executory Contracts and Unexpired Leases" and; (3) the Warrant Agreement is not an executory contract as a matter of law and therefore cannot be rejected.

If rejected, then both sides have different arguments on how the rejection damages should be calculated. The parties requested until close of business on December 5, 2003 to file post-trial briefs. Now having received all evidence, the court finds that the Warrant Agreement is an executory contract, and that rejection is in the best interest of creditors and the estate. The damages stemming from the rejection are \$846,369.85.

Discussion

A. Can the Warrant Agreement be Rejected?

1. Does the Plan Prevent Rejection of the Warrant Agreement?

The Lenders argue that the plan prevents rejection of the Warrant Agreement because the plan states:

Record Holders of Interest in AHP Common Stock shall Retain their Interests.

The Plan then defines record holders as "equity interests in AHP Common Stock or any options, warrants or rights to purchase or acquire such stock."

The Disclosure Statement provides:

Additionally, American HomePatient has in place various stock option plans, pursuant to which options to purchase a significant number of shares of common stock have been issued to current and former employees and directors of the Company. Many of these options have an exercise price so high that they have little or no value. Under existing, applicable

legal principles, the Company believes that these existing options are executory contracts. The Company has not made any decision as to whether it will assume or reject these contracts. If assumed, the existing options and warrants may be exercised after the Effective Date pursuant to their terms. If any of these options or warrants are rejected, then the holder of the rejected contract may have an Unsecured Claim against the Debtor.

The court finds that the Disclosure Statement, when read in conjunction with the Confirmed Plan, does not preclude rejection by the Debtor if the warrants are executory contracts. The Disclosure Statement clearly states that the Debtor considers the warrant agreement to be an executory contract and that the Debtor is considering rejection of same. The plan states that whatever interest the warrant holders had before the plan, they retain such after the plan. In other words, whatever interest the warrant holders had under the Warrant Agreement, they will still have those interests. That interest is as a party to a possible executory contract that might be rejected.

The court therefore overrules the Lender's objection to rejection based on the language of the confirmed plan.

2. Is the Debtor Estopped from Rejecting Warrant Agreement Because the Debtor Failed to List the Warrant Agreement as Executory in its Schedules?

The Debtor did not list the Warrants or Warrant Agreements in Schedule G in the bankruptcy statements and schedules. The debtor's failure to list such, according to the Lenders, is a judicial admission that the warrants are not executory. The Lenders contend that the mere fact that the

debtor may be able to amend their Schedule G is not enough because the failure to include such is a judicial admission. The lenders rely upon *Larson v. Groos Bank, N.A.*, 204 B.R. 500 (W.D. Tex. 1996) (failure to list cause of action in schedules operated as a judicial admission to non-existence of damages in subsequent lawsuit). The Lenders argue that the failure to include the Warrant Agreement judicially estopps the Debtor from rejection of the Warrant Agreement if it is executory.

The Debtor contends that it was oversight not to include the Warrant Agreement. Rule 1009 allows the amendment to a list or schedule as a matter of course at any time before the case is closed. While it is true that courts do not allow amendment to statements and schedules once an intentional deceit is discovered, oversight is the basis for nearly all amendments to statements and schedules. There is no proof to suggest that the Debtor intentionally excluded the Warrant Agreement from Schedule G. In fact, the proof is to the contrary since the Disclosure Statement, that was mailed to ALL creditors included a plain statement that the debtor considered the Warrant Agreement to be an executory contract.

Furthermore, the doctrine of judicial estoppel prevents party from asserting a legal position contrary with one successfully and unequivocally asserted by the same party in a prior proceeding. *In re Duke*, 172 B.R. 575 (M.D. Tenn., 1994). The Debtor has not made a prior successful and unequivocal showing in a prior proceeding. The court therefore, overrules the Lenders' objection on this basis as well.

3. Executoriness is in the Eye of the Beholder

The definition of "executory contract," proposed by Professor V. Countryman in *Executory Contracts in Bankruptcy, Part I*, 57 Minn. L.Rev. 439, 460 is:

a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.

This definition was found by the Sixth Circuit to be helpful but not controlling in the resolution of what is an executory contract. *In re Jolly*, 574 F.2d 349 (6th Cir. 1978). Rather, the Sixth Circuit suggested that in determining whether the contract is executory, the court should work backward from an examination of the purposes to be accomplished by rejection and, if they have already been accomplished, then the contract cannot be said to be executory. *In re Magness*, 974 F.2d 689, 694 (6th Cir. 1992).

This widely cited language in *Jolly* articulates what is called the "functional approach." *In re Sentle Trucking Corp.*, 93 B.R. 551, 557 (Bankr. N.D. Ohio 1988). Under the functional approach, courts must "look first at the results which would obtain if the contract were held to be executory." *Id.* Generally, a court should find the contract executory if such a determination allows the debtor to reject a burdensome or unfavorable contract. A court may find a contract is executory under the functional approach, even though it might not have found the contract to be executory under the Countryman test. *Jolly*, 574 F.2d at 351.

The ultimate purpose behind section 365 is "to allow a trustee to pick and choose among the debtor's agreements and assume those which benefit the estate and reject those which do not." *Phar-Mor, Inc. v. Strouss Bldg. Associates*, 204 B.R. 948, 952-953 (N.D. Ohio, 1997) (quoting *In re G-N Partners*, 48 B.R. 462, 465 (Bankr. D.Minn. 1985)). "Working backwards," then, the court must answer two questions in this case: (1) under the Warrant Agreement does the debtor have material unfulfilled obligations extending into the future? and (2) might the debtor's rejection of the Warrant agreement reasonable benefit the estate?" *Phar-More, Inc. v. Strouss Bldg. Associates* 204 B.R. 948, 952-953 (N.D. Ohio 1997).¹

¹ Judge Lundin explained the inquiry as follows:

The Sixth Circuit arrived at its definition of executory contract through analysis of the purposes of rejection. *Jolly*, 574 F.2d at 351. It determined that a contract is not executory if the objections of rejection "have already been accomplished, or if they can't be accomplished through rejection." *Id.* Those purposes include: (1) taking advantage of contracts which will benefit the estate; (2) relieving the estate of burdensome contracts; (3) promoting the debtor's fresh start; (4) permitting the allowance and determination of the claims; and (5) preventing parties from remaining "in doubt concerning their states vis-a-vis the estate." *See Jolly*, 574 F.2d at 351; *In re Norquist*, 43 B.R. 224, 225, 11 COLLIER BANKR. CAS.2d (MB) 1146 (Bankr. E.D. Wash. 1984); H.R. REP. 595, 95th Cong., 1st Sess. 348 (1977) *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS at 6304.

In re Monument Record Corp., 61 B.R. 866, 868 (Bankr. M.D. Tenn., 1986)(footnotes omitted).

With specific reference to option type contracts, there is a divergence of opinions as to their executoryness. The first line of cases, finds option agreements are executory contracts. *See A.J. Lane & Co.*, 107 B.R. 435 (Bankr. D.Mass. 1989); *In the Matter of Jackson Brewing Company*, 567 F.2d 618 (5th Cir. 1978); *In re Riodizio, Inc.*, 204 B.R. 416 (Bankr. S.D.N.Y. 1997); *In re G-N Partners*, 48 B.R. 462 (Bankr. D.Minn. 1985); *In re Hardie*, 100 B.R. 284 (Bankr. E.D.N.C. 1989); *In re Waldron*, 36 B.R. 633 (Bankr. S.D. Fla. 1984), *rev'd on other grounds*, 785 F.2d 936 (11th Cir.), *cert. dism'd*, 478 U.S. 1028, 106 S.Ct. 3343, 92 L.Ed.2d 763 (1986). The other line of cases, holds that an option contract is typically an *executed* unilateral contract, not an executory contract. *In re Robert L. Helms Constr. & Dev. Co., Inc.* 139 F.3d 702, 705-06 (9th Cir. 1998); *In re Giesing*, 96 B.R. 229, 232 (Bankr. W.D. Mo. 1998); *In re American West Airlines, Inc.*, 179 B.R. 893,896 (Bankr. W.D. Ariz. 1995); *In re Continental Properties Inc.*, 15 B.R. 732, 736 (Bankr. Haw. 1981); *In re National Financial Realty Trust*, 226 B.R. 586, 589-590 (Bankr. W.D. Ky., 1998) (recognizing distinction and adopting minority position that option contracts are not executory).

The court agrees with the Debtor that under the Sixth Circuit's more liberal functional analysis, that the Warrant Agreement is an executory contract. The Warrant Agreement undeniably involves obligations that continue into the future because it obligates the company to sell almost 20% of its stock, if the Warrant Holders exercise their option for the sum of approximately \$32,000. Even though the obligation arises based on a contingency, the contingent nature of the obligation does not prevent the contract from being executory. *In re Phar-Mor*, 204 B.R. 948 (Bankr. N.D. Ohio 1997) (citing *Lubrizol Ents. Inc. v. Richmond Metal Finishers*,

Inc., 756 F.2d 1043, 1046 (4th Cir. 1985) ("contingency of an obligation does not prevent it from being executory.")).

A case, almost precisely on point, *In re Riodizio*, 204 B.R. 417 (Bankr. S.D.N.Y. 1997) provides:

Some have found that Countryman "material breach" test too constraining and static. *In Chattanooga Memorial Park v. Still (In re Jolly)*, 574 F.2d 349 (6th Cir.), cert. denied, 439 U.S. 929, 99 S.Ct. 316, 58 L.Ed.2d 322 (1978) . . .

In this same vein, some advocate a functional analysis which eliminates the requirement of executoriness. See *Westbrook*, supra, 74 Minn.L.Rev. 227; see also Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding Rejection*, 59 U.Colo.L.Rev. 845 (1988) ("Andrew I"); Michael T. Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U.Colo.L.Rev. 1 (1991) (Andrew II"). Under the functional approach, "the question of whether a contract is executory is determined by the benefits that assumption or rejection would produce for the estate." *Sipes v. Atlantic Gulf Communities Corp. (In re General Dev. Corp.)*, 84 F.3d 1364, 1375 (11th Cir. 1996) (affirming on the basis of the district court's opinion, 177 B.R. 1000 (S.D.Fla. 1995)). . . .

The functional approach does not repudiate the Countryman rule; it merely recognizes its limitations. *In re G-N Partners*, 48 B.R. 462, 466 (Bankr. D.Minn. 1985). It also conserves the time and effort that the parties and the court otherwise spend resolving the question of executoriness. But it has its

critics. To be subject to assumption or rejection, the statute, 11 U.S.C. § 365, expressly requires that the contract be executory. Ignoring executoryness rewrites the statute in a fundamental way. *See In re Child World, Inc.* 147 B.R. at 851. ("Manifestly, the[e functional] approach ignores the statutory requirement that the contract to be assumed or rejected must be 'executory.'").

Options agreements, such as the Warrant, demonstrate the shortcomings of the Countryman definition. "[A]n option contract is essentially an enforceable promise not to revoke an offer." *In re III Enterprises, Inc.* V, 163 B.R. 453, 460-61 (Bankr. E.D. Pa), *aff'd*, 169 B.R. 551 (E.D. Pa 1994). It is a unilateral contract until exercised; upon exercise, it becomes a bilateral contract. W. Jaeger, *Williston on Contracts* § 61B (3d ed. 1963); John Calamari & Joseph M. Perillo, *The Law of Contracts* §2-25, at 123 (3d ed. 1987) (an option contract is a hybrid; initially, it is an irrevocable offer, upon exercise, it becomes a bilateral contract); *see also Leslie Fay Cos. v. Corporate Property Assocs. 3 (In re Leslie Fay Cos.)*, 166 B.R. 802, 810 (Bankr. S.D.N.Y. 1994); *In re A.J. Lane & Co.*, 107 B.R. 435, 437 (Bankr. D.Mass 1989).

An option contemplates performance by both parties but requires it from only one. The optionor must keep the offer open. The optionee may but need not exercise the option; if he does, each party must perform its obligations under the resulting bilateral contract. The optionee's failure to exercise the option constitutes a failure of condition rather than a breach of duty. The failure to perform a condition which is

not also a legal duty cannot give rise to a material breach. *In re Columbia Gas Sys. Inc.*, 50 F.3d at 241, see *Merritt Hill Vineyards Inc. v. Windy Heights Vineyard, Inc.*, 61 N.Y.2d 106, 112-13, 460 N.E.2d 1077, 1081-82, 472 N.Y.S.2d 592, 596-97 (1984), and hence, an option contract is not executory under the Countryman definition. *Andrew II, supra*, 62 U.Colo.L.Rev. at 32; see, e.g., *In re America West Airlines, Inc.*, 179 B.R. 893, 896 (Bankr. D.Ariz. 1995) (stock option not executory because optionee has no continuing obligations); *Brown v. Snellen (In re Giesing)*, 96 B.R. 229, 232 (Bankr. W.D. Mo. 1989) (by paying for the option, debtors-optionees fully performed their obligations under the option, and option could not longer be rejected); *Travelodge Int'l, Inc. v. Continental Properties, Inc. (In re Continental Properties, Inc.)*, 15 B.R. 732, 736 (Bankr. D. Haw. 1981) (an option is an executed contract and not an executory contract).

Most courts, however, consider an option to be executory although they reach their conclusions through different routes. *In In re Waldron*, 36 B.R. 633 (Bankr. S.D. Fla. 1984), *aff'd without op.*, (S.D. Fla.) *rev'd on other grounds*, 785 F.2d 936 (11th Cir.) *cert. dismissed*, 478 U.S. 1028, 106 S.Ct. 3343, 92 L.Ed.2d 763 (1986), the debtors granted a real estate option to the Shell Oil Company. The debtors subsequently filed a joint chapter 13 petition in order to reject the contract since the value of the property exceeded the option price.

The *Waldron* court held that the option was executory, but relied on the "some performance due" standard cited in the legislative history rather than the

more rigorous Countryman test. Initially, the court noted that "performance continues to remain due on the part of the Debtors" because they had to keep their offer open. *In re Waldron*, 36 B.R. at 637. In addition, some performance also remained due from Shell. The court assumed, in light of the value of the real estate, that Shell would exercise the option. *Id.* To do so, Shell had to tender its acceptance in accordance with the terms of the option contract, and this "is the performance that foreseeably remains due by Shell or its assignees." *Id.* Further, once Shell exercised the option, "the option contract will immediately transform into an executory contract for the sale of real property." *Id.*

The court reached the same conclusion by an alternative route. Quoting a lengthy passage from *In re Booth*, 19 B.R. 53 (Bankr. D.Utah 1982), the court tacitly acknowledged the limitations of the Countryman test and presaged the functional analysis discussed above. It observed that executory contracts are not measured by the mutuality of commitments but the nature of the parties and the goals of reorganization. Thus, the benefit to the estate rather than the form of the contract controls. *In re Waldron*, 36 B.R. at 637.

The option cases that came after *Waldron*, but adopted the Countryman definition, faced a dilemma. The optionor's obligation—to keep the obligation open—was substantial, but the optionee did not owe any substantial obligation that could result in a material breach. *Andrew II, supra*, 62 U.Colo.L.Rev. at 32. To fit the option contract within the "material breach" test, they conflated the option contract with

the contingent bilateral contract, finding the optionee's duty of substantial performance in the contingent obligation to perform under the bilateral contract created by the exercise of the option. *See, e.g., In re Coordinated Fin. Planning Corp.*, 65 B.R. 711, 713 (Bankr. 9th Cir. 1986); *In re Sundial Asphalt Co.*, 147 B.R. 72, 80 (E.D.N.Y. 1992); *In re Ill Enters., Inc. V*, 163 B.R. at 468-69; *In re Parkwood Realty Corp.*, 157 B.R. 687, 690 (Bankr. W.D. Wash. 1993); *In re A.J. Lane & Co.*, 107 B.R. at 437; *In re Hardie*, 100 B.R. 284, 286-87 (Bankr. E.D.N.C. 1989); *In re G-N Partners*, 48 B.R. at 465.

The case law confirms that executoriness liens in the eyes of the beholder. Despite the contrary case law discussed above, the Warrant, an option contract, is not an executory contract under Countryman's "material breach" test. The debtor granted the option to LLC as additional consideration for the loan. LLC fully performed any legal obligation in connection with the Warrant when it funded the loan. While the exercise of the Warrant is a condition to the debtor's obligation to deliver the shares to LLC, LLC is not legally obligated to exercise the Warrant or do anything (or refrain from doing anything).(FN 4)

FN4. Although LLC also argues that the Warrant is not executory, its reasoning is wrong. LLC erroneously contends that the debtor's only duty under the Warrant is the "ministerial" task of delivering the shares to LLC if it exercises the option to purchase. The debtor must, however, keep the offer open, and under New York law, the failure to do so constitutes a material breach of the

option agreement as well as the contingent bilateral contract. *Cf. Scholle v. Cuban-Venezuelan Oil Voting Trust*, 285 F.2d 318, 320 (2d Cir. 1960) (stock optionor's anticipatory breach of its duty to deliver shares excused optionee's tender and entitled it to recover damages); *Special Situations Fund III, L.P. v. Versus Tech., Inc.*, — A.D. —, 642 N.Y.S.2d 894, 895 (1st Dep't) (same), leave to appeal denied, 88 N.Y.2d 815, 673 N.E.2d 1243, 651 N.Y.S.2d 16 (1996).

If the "some performance due" test in the legislative history is overly inclusive, the Countryman test excludes too much. It imposes a "material breach" requirement, raising the threshold of executoriness above what Congress seemed to intend. In the case of options, it excludes contracts under which the debtor has benefits and burdens, each party must still perform as a condition to the other party's performance, and assumption or rejection may confer a net benefit on the estate. Under the circumstances, we should question the test rather than condemn the contract to a "legal limbo" in which it can be neither assumed nor rejected. *See Westbrook*, *supra*, 74 Minn.L.Rev. at 239.

A test less exclusive than Countryman's that takes into account the mutual performance requirement embodied in the legislative history should be substituted. Under this test, a contract is executory if each side must render performance, on account of an existing legal duty or to fulfill a condition, to obtain the benefit of the other party's performance. Weighing the relative benefits and burdens to the

debtor is the essence of the decision to assume or reject; if each party must still give something to get something, the contract is executory, and the debtor must demonstrate whether assumption or rejection confers a net benefit on the estate. If the debtor has done everything it needs to do to obtain the benefit of its bargain, assumption serves no purpose, and the debtor may simply sue to enforce its rights. Similarly, if the other party has done everything necessary to require the debtor to perform, the debtor's performance adds nothing to the estate, the debtor will not assume the contract, and the other party can file a prepetition claim. Here, the Warrant is executory; each party must perform under the Warrant in order to obtain the benefits under the contingent bilateral contract of sale. To sell the shares and receive payment, the debtor must keep the offer open. To make payment and acquire the shares, LLC must first exercise the option granted under the Warrant.

In re Riodizio, Inc., 204 B.R. 417, 421-424 (Bankr. S.D.N.Y. 1997) (footnotes excluded) (emphasis added). The similarities in the *Riodizio* opinion and this case are inescapable, and the court finds that under the Sixth Circuit *Jolly* standard that the Warrant Agreement is an executory contract. The benefits to the estate in rejecting this contract are blatantly obvious.²

² In their post-trial brief, the Lenders suggest that the Warrant Agreement is not executory because the purported rejection does not prevent the Lenders from obtaining specific performance under applicable state law principles. The court finds this argument unpersuasive. *See generally Leasing Service Corp. v. First Tennessee Bank Nat. Ass'n*, 826 F.2d 434 (6th Cir. 1987) ("[r]ejection denies the right of the contracting creditor to require

Mr. Joseph Furlong's un rebutted and credible testimony clearly established the benefits to the estate from rejection of this executory agreement. Based upon his credible testimony and the legal standards in the Sixth Circuit, the court finds that the Warrant Agreement is an executory contract. Also based on Mr. Furlong's credible testimony, the court finds that rejection demonstrates the debtor's best business judgment. That judgment will not be disturbed unless it is shown there is no reasonable business justification for the decision. Mr. Furlong's testimony provided ample support for the debtor's business decision to reject the Warrant Agreement as an executory contract.

The court therefore overrules all of the Lenders' objections and finds that the Warrant Agreement is an executory contract, and that the Warrant Agreement is hereby rejected. Unfortunately, rejection does not end the parties' dispute. The debtor and the Lenders are at odds as to how the rejection damages are to be calculated.

B. Rejection Damages

Section 365(g)(1) provides:

Except as provided in subsections (h)(2) and (i)(2) of this section, the rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease —

the bankrupt estate to specifically perform the then executory portions of the contract"); *Silk Plants, Etc. Franchise Systems, Inc. v. Register*, 100 B.R. 360 (M.D. Tenn. 1980) (covenant not to compete is not enforceable by injunction against the debtor after rejection of franchise agreement containing the covenant not to compete, but becomes a basis for money damages claim).

(1) if such contract or lease has not been assume under this section or under a plan confirmed under chapter 9, 11, 13 or 13 of this title, immediately before the date of the filing of the petition;

11 U.S.C. 365(g)(1). Pursuant to § 365(g)(1), the rejection is treated as a breach that took place immediately prior to the filing of the bankruptcy petition. *In re Miller*, 282 F.3d 874, 877 (6th Cir. 2002). Thus, a claim is allowable for those damages resulting from the breach, and the Court will determine the amount and validity of the claim as of the date of the breach. 11 U.S.C. §§ 365(g) and 502(g). *See e.g., In re Cochise College Park, Inc.*, 703 F.2d 1339, 1353 & nn.13-14 (9th Cir. 1983) (rejection claim is allowed in the amount which would be recoverable by the non-breaching party as of the petition); *Workman v. Harrison*, 282 F.2d 693, 696, 699 (10th Cir. 1960) (rejection of executory investment contract gives rise to claim for damages in amount of value of the contract at date petition was filed); *Addison v. Langston (In re Brints Cotton Mktg., Inc.)*, 737 F.2d 1338 (5th Cir. 1984) (chapter 7 trustee holding cotton “call contracts” could reject as executory and bankruptcy court did not abuse its discretion in valuing claims for purposes of estimation of claims under section 502(c) as of the petition date); *In re O.P.M. Leasing Services, Inc.*, 79 B.R. 161 (S.D.N.Y. 1987) (when an executory contract is rejected, the claim for damages is fixes as of the petition date so that once the amount of the damages owing to rejection is determined, it must be discounted to its present value as of the petition date); *In re Kent*, 91 B.R. 1 (Bankr. E.D.N.Y. 1988) (damages are “precisely those he could claim if his contract had been breached the day before the petition was filed.”); *In re Al Besade*, 76 B.R. 845 (Bankr. M.D. Fla. 1987)

(damages should be fixed on the day before bankruptcy filing).

Under the statutory framework of the Bankruptcy Code, section 365(g) makes rejection a breach immediately before the date of filing. Section 502(g) then provides that:

A claim arising from the rejection under section 365 of this title or under a plan under chapter 9, 11, 12 or 13 of this title, of an executory contract or unexpired lease of the debtor that has not been assumed shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section, or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.

11 U.S.C. § 502(g). When read together, those sections are consistent with the judicial case law finding that damage stemming from rejection should be determined “as if such claim had arisen before the date of filing the petition.”³ Thus, the court finds that the Code provides for the allowance of the claim arising from rejection in the amount that the Lenders would have recovered as of the time the petition was filed.

Both parties relied upon their witness’ expert testimony to give the court guidance on how the rejection damages should

³ A claim arising from rejection is deemed allowed unless objected to under section 502(a). The parties have, as part of this rejection process, asked the court to determine the amount of the claim. Thus, the court treats the damages issue as claims litigation. A proof of claim relating to the rejection damages has been filed. The court treats the proof of claim, the expert reports, and other evidence as proof of the claim and objections thereto.

be calculated. Testifying for the debtor was Michael Collins,⁴ who concluded the value at \$879,023.00, and testifying for the Lenders was Richard Braun⁵ who concluded that the value was in the range of \$6,528,000 to \$6,764,000. As this court noted in its earlier Opinion discussing confirmation, valuation is an imprecise discipline:

“The valuation of property is an inexact science and whatever method is used will only be an approximation and variance of opinion by two

⁴ Michael Collins is the CEO and Managing Member of 2nd Generation Capital, LLC, a merchant banking an venture capital business headquartered in Nashville. 2nd Generation participates in private offerings as an investment principal and as a placement agent. Mr. Collins is a member of Kraft Bros. Esstman Patton & Harrell, CPAs, based in Nashville. Mr. Collins is a C.P.A. and holder of the specialty designation Accredited in Business Valuation (“ABV”). He has been recognized professionally on numerous occasions. Exhibit 24 sets of Mr. Collins’ complete vitae and qualifications. In addition, Mr. Collins testified that he has extensive experience valuing stocks, warrants and options and has participated in numerous valuations of this type just in the last three months.

⁵ Richard Braun is a Managing Director in the Washington, D.C. office of FTI Consulting, Inc. His responsibilities include the issuance of business valuation opinions, the design and valuation of equity securities, including stock, partnerships, options, warrants and other business interests, the analysis of liabilities including debt, lease obligations, and contingent liabilities, the quantification for economic damages, the determination of premiums and discounts, valuations for tax-related matters such as estate and gift taxes; litigation support and expert witness testimony. Mr. Braun has extensive professional experience and has published works on many of his areas of specialty. His qualifications as a valuation expert are set out fully in his Expert Report found at Exhibit A.

individuals does not establish a mistake in either.” *Boyle v. Wells (In re Gustav Schaefer Co.)*, 103 F.2d 237, 242 (6th Cir. 1939); *see also Rushton v. Commissioner*, 498 F.2d 88, 95 (5th Cir. 1974) (“Valuation outside the actual market place is inherently inexact.”); *In re Montgomery Court Apartments of Ingham County, Ltd.*, 141 B.R. 324, 337 (Bankr. S.D. Ohio 1992) (“Valuations of real property, like projections of income and expenses, are inherently imprecise. Opinions realistically may differ, depending upon the method of valuation used and the nature of assumptions adopted.”); *In re Jones*, 5 B.R. 736, 738 (Bankr. E.D. Va. 1980) (“True value is an elusive Pimpernel.”)

Because the valuation process often involves the analysis of conflicting appraisal testimony, a court must necessarily assign weight to the opinion testimony received based on its view of the qualifications and credibility of the parties’ expert witnesses. *See In re Coates*, 180 B.R. 110, 112 (Bankr. D.S.C. 1995) (“The valuation process is not an exact science, and the court must allocate varying degrees of weight depending upon the court’s opinion of the credibility of . . . [the appraisal] evidence.”). As noted by the Bankruptcy Court for the Southern District of Ohio in *In re Smith*, 267 B.R. 568, 572 - 573 (Bankr. S.D. Ohio 2001), when “weighing conflicting appraisal testimony, courts generally evaluate a number of factors, including: . . . the appraiser’s education, training, experience, familiarity with the subject of the appraisal, manner of conducting the appraisal, testimony on direct examination, testimony on cross-examination, and overall ability to substantiate the basis for the

valuation present." *Id.* (internal citations omitted). A bankruptcy court is not bound to accept the values contained in the parties' appraisals; rather, it may form its own opinion considering the appraisals and expert testimony. *Id.* at 573; see, e.g., *In re Abruzzo*, 249 B.R. 78, 86 (Bankr. E.D. Pa. 2000) ("I am left to some extent with the proverbial battle of the appraisers. Finding merit to both the positions, the only conclusion I can reach is to find some value in between.")

In re American HomePatient, Inc., 298 B.R. 152, 173 (Bankr. M.D. Tenn. 2003). In this case, the debtor argues an estimation of the maximum possible total rejection damages flowing from rejection of the Warrant Agreement is at most \$846,369.85 because the value of the warrants on July 30, 2002 was \$0.2692 per warrant.

To reach this figure, Mr. Collins utilized the Black-Scholes method, a method common in the industry. The Black-Scholes method has the following inputs: (1) time to expiration, (2) annual expected volatility, (3) risk-free interest rate, (4) stock price at time of pricing, and (5) strike price. The model assumes constant volatility and risk-free rate during the option life and no dividends during that time. Mr. Collins noted that all financial pricing models require assumptions, and the three most critical are volatility, price and term. In this case, the price and term were fixed, and volatility assumptions of 100% to 200% produced little changes in his results. Mr. Collins looked back approximately four years and included over the counter trading, and trades on the exchange. He checked his figures against the company figures which also uses the Black-Scholes model. He therefore assumed 150% as a reasonable

assumption of future volatility, which fit nicely with the 142% used by the debtor in its own Black-Scholes calculations.

Mr. Collins concluded that based upon the wide fluctuation in closing prices for the preceding thirty days and the high volatility of the securities over time, and the low trading value, that the fair market value of the securities was \$0.27 based on a thirty day average, but in any event not greater than \$0.32 (the closing price on July 30, 2002).

Mr. Collins testified carefully and credibly about the extensive "counter-checks" or sensitivity checks he performed to insure the validity of his numbers. Mr. Collins utilized an ex-post approach to determine the value of the warrants immediately prior to the petition, but did use information that became available after the petition date to check the sensitivity of his figures. Mr. Collins credibly explained why the warrant price of \$0.2692 per share was a correct valuation in this case.

Mr. Braun did not employ the Black-Scholes method. In his opinion, the Black-Scholes method was an inappropriate valuation tool in this case because the options were "in the money." Mr. Braun concluded that because the warrants were "deep in the money" (stock price greater than the exercise price), that a "Formula Value" approach would produce a more reliable value. Mr. Braun reached his ~~\$6,528,000.00 to \$6,764,000.00~~ value range by taking the terminal value of the company in 2009, based on the debtor's financial consultants' projections, and discounting the amount back to July 30, 2002. In other words, Mr. Braun used Houlihan Lokey Howard & Zukin's financial projections prepared in association with plan confirmation, to determine an underlying equity value for the company, to compute a warrant value. Mr. Braun's approach used an ex-ante

procedure whereby he considered knowledge and information after July 30, 2002 to achieve an accurate estimate of the value of the warrants as of day prior to the petition.

Although the court found Mr. Braun to be a credible and knowledgeable witness, his expert report was less helpful to assist the court in the damages calculation based on the court's duty to set damages that the Lenders would have recovered as of the time the petition was filed. In other words, the most accurate predictor of what the Lenders would have recovered as of the fictitious breach immediately before the petition is the "snap-shot" analysis Mr. Collins provided. Furthermore, the court found Mr. Collins' testimony to be thorough and credible. When "weighing conflicting appraisal testimony, courts generally evaluate a number of factors, including: . . . the appraiser's education, training, experience, familiarity with the subject of the appraisal, manner of conducting the appraisal, testimony on direct examination, testimony on cross-examination, and overall ability to substantiate the basis for the valuation presented." *In re American HomePatient, Inc.*, 298 B.R. 152, 173 (Bankr. M.D. Tenn. 2003) (quoting *In re Smith*, 267 B.R. 568, 572-573 (Bankr. S.D. Ohio 2001)). After considering all of these factors, and the experts' reports as a whole, the court finds Mr. Collins' testimony to be more persuasive, and helpful in the court's analysis. Accordingly, the court credits Mr. Collins' testimony on the valuation of the warrants as of July 30, 2002.⁶

⁶ Mr. Braun's valuation relies upon projections produced by the debtor's own financial advisors. However, those figures were utilized to demonstrate the feasibility of the debtor's proposed plan of reorganization. On July 30, 2002, only a crystal ball could have said for sure that the court would accept those projections as feasible and that the plan would be confirmed as proposed. It is

The court, therefore, finds that the proper valuation of the warrants on the date immediately prior to the petition was \$.02692 per warrant. When the per warrant value is reduced by the exercise price of \$0.01 per warrant, (\$.02592) and multiplied by the total number of warrants (\$3,265,315), the resulting damages stemming from the rejection of the executory Warrant Agreement is \$846,369.85. The court finds that this provides the Lenders with exactly the amount they would have been entitled to immediately prior to filing, and is consistent with the mandates of 11 U.S.C. §§ 365(g) and 502(g).⁷

Conclusion

The court overrules all the Lender's objection to the Motion to Reject the Warrant Agreement. The court finds that the Warrant Agreement is an executory contract and that the resulting damages stemming from the rejection of the

almost counter-intuitive that the Lenders continue to contest confirmation on appeal based, at least in part, on the issue of feasibility, yet rely on those same numbers to arrive at a valuation suitable to inflate their damages upon rejection of the warrants.

⁷ The Lenders contend that treating the Warrant Agreement as executory leads to an "illogical result" because after rejection on July 11, 2003, the debtor could refuse to deliver a share of stock to a warrant holder; pay the warrant holder \$0.2692; sell the same share for \$2.15 (the share price on July 11, 2003) "and pocket the profit of \$1.88 thereby profiting from an intentional breach." To the contrary, this shows the inherent propriety in rejection of the Warrant Agreement. See e.g. *In re Riodizio, Inc.*, 204 B.R. 417, 425 (Bkrtcy. S.D.N.Y. 1997) ("If LLC suffered any damage, this goes far to proving the wisdom of rejection; the debtor can sell the shares (to LLC or a third party) for more than the per share price of \$1.00, and pay LLC's claim in tiny bankruptcy dollars).

executory Warrant Agreement are \$846,369.85. The debtors shall prepare an order not inconsistent with this Opinion within ten (10) days of entry of this Memorandum.

It is therefore so ORDERED.

This ____ day of December, 2003.

/s/

George C. Paine, II
Chief Judge
United States Bankruptcy Court

(2)
No. 05-859

FILED

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**In the
Supreme Court of the United States**

NEXBANK SSB, ET AL.,

Petitioners,

v.

AMERICAN HOMEPATIENT, INC., ET AL.,

Respondents.

**On Petition for a Writ of Certiorari to the United
States Court of Appeals for the Sixth Circuit**

RESPONDENT'S BRIEF IN OPPOSITION

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QUESTION PRESENTED

The question presented is whether the plain language of § 502(g) of the Bankruptcy Code requires that a claim arising from the rejection of an executory contract must be determined and allowed as if such claim had arisen before the date of the filing of the bankruptcy petition.

RULE 29.6 STATEMENT

American HomePatient, Inc. (a Delaware corporation) as substantively consolidated with 24 of its subsidiaries under its confirmed Chapter 11 Plan ("AHP," or the "Respondents") is a publicly-held company, but is neither a subsidiary nor an affiliate of a publicly owned corporation, nor is there any publicly held company that owns 10% or more of the stock of AHP.

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STATEMENT OF THE CASE

In accordance with the plain and unambiguous language of §§ 365(g) and 502(g) of the Bankruptcy Code, courts of appeal and lower courts across the circuits have consistently held (a) that rejection of an executory contract constitutes a breach of that contract as of the date immediately before the petition date and (b) that damages arising from that rejection shall be determined and allowed the same as if such claim had arisen before the date of the filing of the petition. The consistency of the law in this area is not surprising; the language of the Bankruptcy Code is clear and straightforward. Respondents do not dispute that the application of §§ 365(g) and 502(g) to the computation of rejection damages claims is both pervasive in bankruptcy proceedings and an important question of federal bankruptcy law, however this important question is, in the words of the courts below, a “seemingly clear area of the law” and an area of “general agreement” among lower courts. Pet. App. 21a and 10a, respectively. Contrary to the assertions of the Petitioners, there are no gaps in federal bankruptcy law in this area such that resort to state law is necessary or appropriate, and the clear mandates of the Bankruptcy Code as set forth in §§ 365(g) and 502(g) preempt any contrary state laws. Finally, the decision of the court of appeals below does not contradict, in principle or otherwise, either cited decision from the First or Fifth Circuit and was correctly decided on the merits.

A. Statutory Context

Petitioners correctly cite to the relevant provisions of the Bankruptcy Code, §§ 365(g) and 502(g). The Petitioners’ discussion of the effect of these two provisions on the calculation of a rejection damages claim, however, is myopic. Petition for Writ, p. 3-4. The plain language of § 502(g)

cannot be ignored: a claim arising from rejection of an executory contract shall be “*determined*, and shall be *allowed ... as if such claim had arisen before the date of the filing of the petition.*” As the plain meaning of the statute is clear and without gaps, no resort to state law and no interpretation is needed. Attempting to explain this language out of existence will not make it any less applicable when rejection damages are to be calculated.

B. Factual Background

Petitioners recitation of the factual background of this case is largely accurate as far as it goes. The following are additional salient facts, as noted by the courts below, relevant to this Court’s consideration of the Petition for Writ. It was not until Petitioners filed their pre-trial brief on the day of the hearing before the Bankruptcy Court that Petitioners suddenly proffered the new theory that the appropriate date for calculating rejection damages is the date the Warrant Holders “learned of the breach.” Pet. App. 7a. (R1 (BR), Pre-Trial Memo., Apx. 305) Petitioners’ expert witness only expressed an opinion as to damages calculated as of July 30, 2002, the day before the Petition Date. Pet. App. 6a. (R1 (BR), Tr. 11-21-03 (Braun) at 277, lines 4-16, Apx. 650) (“Q: The date of valuation you used was July 30, 2002, correct? A: Yes. Q: And that date was provided to you by your counsel? A: Yes. Q: They did not request that you do a valuation as to any other date; is that correct? A: Correct. Q: You’ve never done a valuation as of July 11, 2003; is that correct? A: Correct.”); (R1 (BR), Ex. A (Expert Report) at 1, Apx. 948) Petitioners did not offer any evidence in support of a rejection damages calculation as of any date other than July 30, 2002. Pet. App. 6a. (R1 (BR), Tr. 11-21-03 (Braun) at 277, lines 4-16, Apx. 650)

C. Court of Appeals' Decision

Despite the somewhat disparaging tone of Petitioners, the court of appeals did more than consult an on-line dictionary in its disposition of this case. After reviewing the proceedings before the bankruptcy court, including noting the lack of any evidence offered by Petitioners as to damages calculated as of any date other than the date immediately prior to the petition date, the court of appeals discussed accepted rules of statutory construction including the requirements that courts must "read statutes and regulations with an eye to their straightforward and commonsense meanings" and "give effect, if possible, to every clause and word of a statute." Pet. App. 9a. Applying these principles, the court of appeals thus determined that the language of § 502(g) was clear and means what it says: "we conclude that section 502(g) requires that damages be fixed as of a date 'before the date of the filing of the petition. 11 U.S.C. § 502(g). Indeed, consistent with section 365(g)(1), we conclude that damages should be fixed as of the time of the deemed breach, which is 'immediately before the date of the filing of the petition.' 11 U.S.C. § 365(g)(1)."

The court of appeals' analysis, however, did not end there. The court went on to survey judicial opinions construing § 502(g) and determined that its conclusion was consistent with a "general agreement" existing among courts of every level across the circuits on the issue of from what date rejection damages must be calculated. Ultimately, the court of appeals concluded that "[b]ecause the language of the statute as well as the caselaw supports the Bankruptcy Court's decision to value damages as of the date immediately before the date of the filing of the petition, and because *all* of the testimony presented to the Bankruptcy Court regarding the calculation of damages was based on that pre-petition value

date, [Petitioners'] assertion of error in this regard is not well-taken." Pet. App. 12a.

Finally, the court of appeals considered and rejected Petitioners' argument that the relevant date for calculating its rejection damages was a wholly different date proscribed by New York law rather than the date set forth in the Bankruptcy Code. Finding that the Bankruptcy Code specifically set the relevant date for calculation of rejection damages claim in § 502(g), the court of appeals found no gap in federal law that New York state law needed to fill: "As these specific provisions [of the] leave no "gap" and, therefore, control any conflicting provisions of state law, the Bankruptcy Court did not err when it relied on the July 30, 2002, pre-petition date as the valuation date. The Bank's arguments to the contrary are without merit." Pet. App. 14a.

SUMMARY OF ARGUMENT

Upon the filing of a Chapter 11 case, the parties to executory contracts, such as the Warrant Holders, have a potential, contingent, prepetition claim for rejection damages. That claim may or may not ever become allowable by the occurrence of the contingency, it depends on whether the debtor ultimately decides to reject the contract. But the "claim" itself exists immediately as of the filing of the petition as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured[.]" 11 U.S.C. § 101(5). The Warrant Holders' contingent rejection damages claim became a "claim" that was subject to determination and allowance pursuant to §§ 365(g) and 502(g) as soon as Respondents filed Chapter 11. A claim for damages flowing from the rejection of an executory contract is governed by § 502(g) which